# International Project Finance

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PUBLISHED UNDER THE AUSPICES OF THE CENTER FOR INTERNATIONAL LEGAL STUDIES

Transnational Publishers, Inc.
Ardsley, New York

Published and Distributed by *Transnational Publishers, Inc.*
Ardsley Park Science and Technology Center
410 Saw Mill River Road
Ardsley, NY 10502

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Phone: 914-693-5100
Fax: 914-693-4430
E-mail: Info@transnationalpubs.com
Web: www.transnationalpubs.com

**Library of Congress Cataloging-in-Publication Data**

International project finance / general editor, Dennis Campbell; editors, Fiona Scott, Claus-Peter Martens.

p. cm. -- (International business law practice series)

"Published under the auspices of the Center for International Legal Studies."

ISBN 1-57105-139-2 (title) -- ISBN 1-57105-110-4 (series)

1. Economic development projects--Finance--Law and legislation 2. Public Works--Law and legislation. 3. Privatization--Law and legislation. 4. Infrastructure (Economics)--Finance. I. Campbell, Dennis. II. Scott, Fiona. III. Martens, Claus-Peter,1960-IV. Series.

K3840 .I6 2001
346.02'3--dc21

00-053678
CIP

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Manufactured in the United States of America

# TABLE OF CONTENTS

**Authors** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ix

**Preface** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . xix

**Chapter 1, International Standard Form Contracts**
*by* William Karl Wilburn . . . . . . . . . . . . . . . . . . . . . . . . . 1

**Chapter 2, UNCITRAL Legislative Guide for Privately Financed Infrastructure Projects**
*by* Tore Wiwen-Nilsson . . . . . . . . . . . . . . . . . . . . . . . . . 7

**Chapter 3, Foreign Financing of Infrastructure Projects in Brazil**
*by* Marcos Chaves Ladeira . . . . . . . . . . . . . . . . . . . . . . . . 15

**Chapter 4, Project Financing in Canada: Project Developer and Financing Methods**
*by* Bogdan Teofilovici . . . . . . . . . . . . . . . . . . . . . . . . . 29

**Chapter 5, The Colombian Power Sector — Project Finance and Investment**
*by* Maria M. Zuleta . . . . . . . . . . . . . . . . . . . . . . . . . . 45

**Chapter 6, Project Finance in a Troubled Chinese Market**
*by* Anthony W.Y. Chan and Elaine Yu . . . . . . . . . . . . . . . . . . 57

**Chapter 7, Project Finance — The German View**
*by* Ulf R. Siebel . . . . . . . . . . . . . . . . . . . . . . . . . . . . 81

**Chapter 8, Privatization Aspects of Project Finance in Greece**
*by* Gus J. Papamichalopoulos . . . . . . . . . . . . . . . . . . . . . . 91

**Chapter 9, The New Italian Law on Project Finance**
*by* Fabrizia Maurici . . . . . . . . . . . . . . . . . . . . . . . . . . 115

**Chapter 10, Guarantees in Project Finance in Spain**
*by* Javier Pérez-Ardá Criado . . . . . . . . . . . . . . . . . . . . . . 123

**Chapter 11, Build, Operate, Transfer Project Financing in Emerging Countries**
*by* Peter Neumann . . . . . . . . . . . . . . . . . . . . . . . . . . . 133

**Chapter 12, Towards Sustainable Build Operate Transfer Projects in Asia**
*by* Austin I. Pullé . . . . . . . . . . . . . . . . . . . . . . . . . 165

**Chapter 13, Securing United States Assets on Multinational Projects**
*by* Justin Weisberg. . . . . . . . . . . . . . . . . . . . . . . . . 181

**Chapter 14, Public Procurement in Germany**
*by* Gabriele Heise . . . . . . . . . . . . . . . . . . . . . . . . . 201

**Chapter 15, Privatization in Romania**
*by* Dragos Vilau . . . . . . . . . . . . . . . . . . . . . . . . . 215

**Chapter 16, Environmental Legal Issues in Project Finance and Mergers and Acquisitions**
*by* John M. Scagnelli . . . . . . . . . . . . . . . . . . . . . . . . . 233

**Chapter 17, European Environmental Law — Public and Major Projects**
*by* Michael Redman . . . . . . . . . . . . . . . . . . . . . . . . . 243

**Chapter 18, Water and Wastewater Resource and Infrastructure Master Planning, Financing, and Conflicts**
*by* Kevin Patrick. . . . . . . . . . . . . . . . . . . . . . . . . 255

**Chapter 19, Cultural Issues in International Arbitration**
*by* David A. Lawson . . . . . . . . . . . . . . . . . . . . . . . . . 269

**Chapter 20, Dispute Resolution in Major Infrastructure Projects**
*by* Christian Camboulive . . . . . . . . . . . . . . . . . . . . . . . . . 281

**Chapter 21, Dispute Resolution and Construction Contracts**
*by* Tim Reynolds . . . . . . . . . . . . . . . . . . . . . . . . . 299

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# PREFACE

This publication presents a close consideration of the complex issues connected with international project finance. These issues range from project finance structures, privatizations, and the role of international finance institutions, private and public projects in specific regions of the world, and the environmental implications of projects, to dispute resolution and arbitration.

The "gap" is the essence of project finance. Put simply, international project finance is about bridging the gap between conception and realization; between the existing situation and the future; and between the funding requirement and the financing solution. It is essentially about bridging the gap between investors and the scope for investment around the globe; the gap between the developed and the developing countries of the world; the gap between public and private sectors; and the gap between different cultures, countries, and legal and political systems.

Within a country, project finance may bridge the gap between the public and private sectors. It may also lead to cooperation between the public and private sector institutions, to restructuring and privatization, and to a more comprehensive government regulation system. Project finance influences infrastructure sector reform movements in industries, e.g., electricity. International project finance can exert pressure to close the gap between the regulatory framework in place and the framework necessary for the evolution of sectors towards competitive commercial operations.

The World Bank and other international institutions like the International Finance Corporation (IFC) and the Inter-American Development Bank (IDB) have a special role as promoters of long-term sector reform of local legal and institutional systems. Governments, too, have a particular responsibility to provide protection for investors and consumers, often in the form of government guarantees. Experience has shown that partially privatized structures, e.g., Pakistan and Indonesia, cannot be sustained. More complete market models, e.g., in Latin America, enjoy a greater success because of their substantial consumer benefits; there are also benefits for the general economic development because a better quantity and quality of basic service is available. Direct foreign investment may lead to higher investment in sectors like utility infrastructure in developing countries as local capital markets are inadequate. There must be legal and fiscal incentives for attracting investment and once the investment is made, it must be sufficiently protected.

In this context, there is scope for project finance to play a fundamental role in closing other gaps and achieving further objectives, aside from financing the realization of a project. Project finance may improve social and economic situations of the country, e.g., favorably influencing social issues, human rights, and the protection of natural resources.

In many cases, international project finance is ultimately about spanning the considerable gap between the developed and the developing countries of the world. Financial crises in major emerging national economies have, for instance, paved the way for significant influence by project finance on infrastructure projects and reform policies.

Project finance is like a bridge—engineered by necessity, crossing cultural divides, forging links between differing legal, economic, and social systems in often vastly different countries. International pipeline projects involve not only the deregulation of oil and gas sectors, but they also present a challenge to government and project sponsors to overcome legal and political risks, e.g., the Western African gas pipeline project. Project finance is about resolving tensions, bridging what seems like an insurmountable gap between the parties' complex and competing interests, e.g., inter-creditor disputes. Lastly, project finance involves finding ways to bridge the gap when the project's objectives have broken down. Lawyers and project managers are forced to find ways across the divide of payment defaults, consider enforcement measures, reschedule construction work, and restructure the project.

*International Project Finance* is a valuable and informative publication, which will enable legal practitioners and academics to grasp a real understanding of the complex issues connected with international project finance.

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# CHAPTER 1
# INTERNATIONAL STANDARD FORM CONTRACTS

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## A. IN GENERAL

This chapter will discuss some of the major international standard form contracts, specifically the *Fédération Internationale des Ingénieurs-Conseils* (FIDIC) series of new contracts and some of their major differences. Determination of which contract to use, or more likely, which provision of which contract to specially apply, can only be made after a careful review of the party's risks and a comparison of model contract forms.

Some of the major model contracts for international projects are issued by the following organizations:

(1) The *Fédération Internationale des Ingénieurs-Conseils*[1] — The FIDIC or the International Federation of Consulting Engineers (translated) is an umbrella association of national associations of consulting engineers, established in 1913 with its headquarters in Lausanne, Switzerland. In 1957, the FIDIC began issuing a series of documents governing international civil engineering projects. The FIDIC has issued forms covering many different areas of contracting.[2] Three of the FIDIC forms (Orange, Yellow, and Silver Books) are discussed below.

(2) Institution of Civil Engineers (ICE)[3] — The ICE is the primary civil engineering society of the United Kingdom. The ICE's first edition of standard contract forms was published in 1945. The most recent ICE

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[1] Corbett, *FIDIC 4th A Practical Legal Guide*, 1991.

[2] FIDIC documents may be ordered from: FIDIC, P.O. Box 86, CH-1000 Lausanne 12-Chailly, Switzerland, Telephone: (41 21) 19654 4415, Telefax: (41 21) 19653 5432, Email: 106223.2246@compuserv.com.

[3] The ICE contract may be ordered from Thomas Telford Services Limited, 1 Heron Quay, London, E144JD, England.

form, the sixth edition, was issued in 1991 — The ICE document forms are frequently encountered on projects in regions of the world presently or formerly under British influence. Contractors and lenders from the United Kingdom frequently prefer them.

(3) The World Bank (through the International Bank for Reconstruction and Development and the International Development Association).[4]

(4) The Engineering Advancement Association of Japan (ENAA).[5]

Because of their widespread use, this chapter will focus on the use of FIDIC forms in international projects.

## B. THE FIDIC RAINBOW: AN OVERVIEW

In 1957, the FIDIC issued the FIDIC First Edition Red Book, "Conditions of Contract (International for Works of Civil Engineering Construction)". Since then, the FIDIC has attempted to keep pace with the demands of international contractors for a standardized set of model contracts. FIDIC books are best known by the color of their jacket covers. The Red Book, essentially a design-bid-build format, became unwieldy for newer innovations in project delivery formats such as design-build and Build Operate Transfer (BOT) financed projects. Accordingly, in 1995, the FIDIC issued its Orange Book, "Conditions of Contract for Design-Build and Turnkey".

In 1998, the FIDIC further differentiated its array of model contracts by issuing four new editions of contracts. A new test edition of the time-proven Red Book, and test editions of the altogether new Green Book, "Short Form of Contract", a Yellow Book "Conditions of Contract for Plant and Design-Build for Electrical and Mechanical Plant and for Building and Engineering Works, Designed by the Contractor",

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[4] Copies of the Sample Bidding Documents, Procurement of Works, and other World Bank forms and literature may be obtained from the World Bank at 1818 H Street N.W., Washington, D.C. 20433, United States.

[5] International Contract for Process Plant Construction (Turnkey Lump Sum Basis) with Process Licence (sic) — Form of Agreement & General Conditions, 1992 Edition. See also "The New ENAA Model Form of Contract", 13 *International Construction Law Review* 482 (October 1996); Hiromi Hoshi, "ENAA Model Form of Contract for Power Plant Construction", 14 *International Construction Law Review* 61 (Jan. 1997); and Tore Wiwen-Nilsson, "The 1996 Edition of the ENAA Model Form-International Contract for Power Plant Construction-A Brief Review", 14 *International Construction Law Review* 273 (July 1997). Forms may be obtained from: Engineering Advancement Association of Japan, Toranomon Takagi Building 7-2, Nishi-Shinbashi t-chome Minato-ku, Tokyo 105, Japan. Telephone: (81 3) 3602 4441, Telefax (81 3) 3502 5500.

and a Silver Book, "Conditions of Contract for EPC Turnkey Projects".[6] The present discussion will focus on the FIDIC Orange, Yellow, and Silver Books, which all pertain to design-build contracting.

More specifically, these FIDIC standard form contracts can be summarized as follows:

(1) The Red Book is applicable for design-bid-build projects. It is essentially comprised of two companion documents. Part I serves as the basic document form and Part II offers special replacement or supplementary terms, depending on the parties' unique circumstances, which are keyed to specific provisions in Part I. It is estimated that the FIDIC Civil Form is the standard form for as much as 30 per cent of civil works in the Middle East and most World Bank finance projects. The United States Agency for International Development (AID) recommends that the FIDIC Civil Form be used.

(2) The Green Book (Short Form of Contract) First Edition, 1999, contract is intended for use on projects under US $500,000.

(3) The Orange Book (discussed below).

(4) The Yellow Book (discussed below).

(5) The Silver Book (discussed below).

It is difficult to develop a model contract from BOT projects. The reason for this is that most aspects of such projects are unique; the design of the project, the constellation of interested participants and parties, and the set of risks which each party faces. Each party will try to minimize these risks by shifting the risks to others. Numerous agreements are required to knit the project participants together. These include the Credit Agreement, Shareholders' Agreement, Concession Agreement, Power Purchase Agreement, Operating and Maintenance Agreement, and Fuel Supply Agreement. Each of these agreements must be specially tailored to the needs of the particular parties. However, one agreement that may lend itself to standardization is the Construction Contract itself.

Although the FIDIC Orange Book was not specifically drafted for use in BOT projects, it nevertheless may serve as one possible "standardized" contract to govern

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[6] Booen, "FIDIC's Conditions of Contract for the Next Century: 1998 Test Editions", 16 *International Construction Law Review* (January 1999), at p. 5; Hoyle, "FIDIC Design-Build Turnkey and EPC Contracts", 16 *International Construction Law Review* (January 1999), at p. 27; Corbett, "FIDIC's New Rainbow-An Overview of the Red, Yellow, Silver, and Green Test Editions", 16 *International Construction Law Review* (January 1999), at p. 39; and Sandberg, "A Contractor's View on FIDIC Conditions of Contract For EPC Turnkey Projects", 16 *International Construction Law Review* (January 1999), at p. 47.

the relationship between the "Employer", i.e., the "Owner" or *Auftraggeber* (in German), or "Project Company", and the design-build contractor. The Orange Book is suitable because most such BOT projects utilize a design-build framework. The structure of the Orange Book lends itself to such calibration. Part I contains a model on "General Conditions", and Part II contains "Guidance for the Preparation of Conditions of Particular Application" which comprise alternative or supplementary terms which can be included or modified to meet a particular situation.

Part II offers an extensive supplementary structure for clause 13, Contract Price and Payment, an especially important issue for BOT projects. The Orange Book's provisions in clause 10 with respect to the take-over of the works by the owner (typical on a normal design-build project) obviously need to be examined carefully since, in a BOT project, the Operator takes over the works, in conjunction with the terms of the Concession Agreement.

## C. FIDIC YELLOW BOOK "CONDITIONS OF CONTRACT FOR ELECTRICAL AND MECHANICAL WORKS (1998)"

The FIDIC Yellow Book is an attempt to address some of the deficiencies in the Orange Book. Some commentators have questioned whether the FIDIC would have been better off revising the Orange Book instead.[7] The FIDIC states that the Orange Book is suitable for works "which may include any combination of engineering (including civil, mechanical, and electrical) and building works", whereas the new Yellow Book is to be used "for the provision of electrical and/or mechanical plant, and for the design and execution of building or engineering works". Judging from this, there would appear to be little difference between the two model contracts.

As a generalization, in the Yellow Book the allocation of risk between employer and contractor insofar as design-build contracts are involved has shifted and placed more risk on the contractor.[8] Major drafting changes in the Yellow Book include a new definition of "defects notification period" (one year from completion unless otherwise provided); employer's claims (not present in the Orange Book); the engineer (replaces the Orange Book's "employer's representative", but the duties are similar); training requirements (contractor is required to provide training); and remedial work (expanding contractor's duties to perform).[9]

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7 Huse, "Use of the FIDIC Orange Book in the Context of a BOT Project", 13 *International Construction Law Review* 434 (October 1996), at p. 32.

8 FIDIC, Yellow Book, clause 5.1.

9 Huse, "Use of the FIDIC Orange Book in the Context of a BOT Project", 13 *International Construction Law Review* 434 (October 1996), at pp. 28–32.

## D. FIDIC SILVER BOOK "CONDITIONS OF CONTRACT FOR EPC TURNKEY PROJECTS"

The FIDIC intended the Silver Book to serve as a strict two-party (employer and contractor) model for an engineering procurement construction (EPC) turnkey contract, where the contractor takes full responsibility for design. This contrasts with the Yellow Book's retention of the "engineer" as a party to the contract.

The Silver Book includes most of the changes discussed above in the Yellow Book, and goes even further in assigning maximum risk to the contractor. For example, there is no intermediary such as an engineer (under the Yellow Book), although, if the employer so chose, it could appoint an "employer's representative" with powers similar to those under the Orange Book. The contractor is responsible for "verifying" the employer's site data,[10] whereas the Yellow Book has no similar provision. The new Yellow Book permits a contractor's time extension and compensation for unforeseeable subsurface conditions,[11] but the Silver Book does not provide for this.

## E. CONCLUSION

There is no single standard form contract or set of contracts that serve as models for international projects. Instead, the parties are best served by identifying the array of relationships which comprise the project in its totality and seek to tailor each agreement to protect the respective parties' interests and minimize their risks.

For BOT projects, the FIDIC Orange, Yellow, and Silver Books may all serve as a good starting point for the agreement between the employer and the contractor.

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10 FIDIC, Silver Book, clause 4.12.

11 FIDIC, Silver Book, clause 4.12.

CHAPTER 2

# UNCITRAL LEGISLATIVE GUIDE FOR PRIVATELY FINANCED INFRASTRUCTURE PROJECTS

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## A. INTRODUCTION

Political and commercial trends and constraints on public budgets have opened up new opportunities for the public sector to obtain private financing and for private parties to invest in those projects historically available only to the public sector. This is the case in industrial countries but also in emerging economies.

In line with this trend, the United Nations Commission on International Trade Law (UNCITRAL) has initiated the drafting of a Legislative Guide on Privately Financed Projects. During its sessions in 1998 and 1999, the General Assembly considered draft chapters of such a Guide. Currently, a final version is being prepared for the Commission's consideration in June 2000.

Although the Legislative Guide is not yet finished, it should nevertheless be of great interest to representatives of the public sector and representatives of the private sector to obtain a first impression of its suggested contents, because there is no doubt that, when finished, it will greatly influence countries in setting up the legal framework for privately financed infrastructure projects.

It must be observed, however, that the suggested Guide, in May 1999, was discussed at the session of the General Assembly of UNCITRAL, and that revisions were made as a result of views expressed at the session. Some of the revisions may well be substantial as to the contents of the Guide.

## B. PURPOSE AND SCOPE OF THE GUIDE

The following is a quote from the report of the Secretary-General to the General Assembly on the session on June 1–12, 1998 in relation to the Guide:

> The purpose of the Guide is to assist national authorities and legislative bodies wishing to establish a favourable legal framework for promoting infrastructure development through private investment. The advice provided in the Guide aims to achieve an appropriate balance between the need to facilitate private participation in infrastructure projects and the need to foster the interests of the host Government and the public. In addition to legislative and policy-making bodies, the Guide may be of interest to other authorities, at national or local level, involved in the execution of privately financed infrastructure projects.
>
> The Guide is intended to be used as a reference in the preparation of new laws or in the review of the adequacy of existing laws and regulations.[1]

The Guide is primarily concerned with new projects in which private parties participate in the financing, construction, maintenance, and operation of public infrastructure in exchange for the right to charge a price. However, many aspects dealt with are also applicable to projects where the private party takes over an existing facility. Typically, these projects involve the provision of services or commodities to the public directly or through an intermediary.

The Guide in its present form does not apply to transactions with private investment which do not involve infrastructure development and operation, such as sale of state-owned land or sale of shares of state-owned companies. Nor does it cover projects for the exploitation of natural resources. The size, location, or nature of the infrastructure project has no relevance to the applicability of the Guide. Thus, it also applies to small and medium-sized projects.

If the Guide is used adequately by the legislator, it will create a robust and trustworthy environment, speed up the procurement and implementation processes, and lead to cost efficiency. In particular, the cost saving aspects are important. A streamlined approach will create the best opportunities for the implementation of privately financed infrastructure projects.

## C. SUGGESTED CONTENTS OF THE GUIDE

### 1. In General

The Guide is intended to cover a very broad spectrum of issues relevant to privately financed infrastructure projects. It will include those issues which are specific to projects but also those issues which are of a more general application such as corporate law, tax and investment, and protection issues.

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1 A/CN444/Add., March 12, 1998.

## 2. Headings

The suggested table of contents includes at present the following headings:

**Scope, Definitions, and Background Information on Privately Financed Infrastructure Projects**

| | |
|---|---|
| **Chapter I** | **General legislative and institutional framework** |
| | Constitutional and legislative framework |
| | Scope of authority to award concessions |
| | Administrative coordination |
| | Authority to regulate infrastructure services |
| **Chapter II** | **Project risks and government support** |
| | Project risks and risk allocation |
| | Government support |
| | Guarantees provided by international institutions |
| | Guarantees provided by export credit agencies and investment promotion agencies |
| **Chapter III** | **Selection of the concessionaire** |
| | General considerations |
| | Preselection of bidders |
| | Procedures for requesting proposals |
| | Direct negotiations |
| | Unsolicited proposals |
| | Review procedures |
| | Notice of project award |
| | Record of selection and award proceedings |
| **Chapter IV** | **Construction and operation of infrastructure** |
| | General considerations on the project agreement |
| | Core terms of the project agreement |
| | Statutory and contractual provisions on construction works |
| | Statutory and contractual provisions on the operation of infrastructure |
| | General contractual arrangements |
| **Chapter V** | **Duration, extension, and termination of the project agreement** |
| | General remarks |
| | Extension of the project agreement |
| | Termination |
| | Consequences of expiry or termination of the project agreement |

**Chapter VI** **Governing law**

General remarks

The law governing the project agreement

The law governing contracts entered into by the concessionaire

**Other relevant areas of legislation**

Promotion and protection of investment

Property law

Rules and procedures on expropriation

Intellectual property law

Security interests

Company law

Accounting practices

Contract law

Rules on government contracts and administrative law

Insolvency law

Tax law

Environmental protection

Consumer protection laws

Anti-corruption measures

**International agreements**

Membership in multilateral financial institutions

General agreements on trade facilitation and promotion

International agreements on specific industries

**Chapter VII** **Settlement of disputes**

Disputes between the contracting authority and the concessionaire

Disputes between the concessionaire and its lenders

Disputes involving other parties

Disagreements between the regulatory body and the concessionaire

In the beginning of each chapter, there is a set of legislative recommendations.

## D. SUMMARY OF CONTENTS

### 1. Definitions and Background

The introduction describes the purpose and scope of the Guide, defines terms used, and gives some background information. The background information gives an overview of basic issues of privately financed infrastructure projects, such as forms of private participation, how these projects are financed, who the parties involved are, the role of the host government, the different phases of the project, and how to select the concessionaire.

### 2. Chapter I — General Legislative and Institutional Framework

Chapter I of the Guide identifies that constitutional law may contain provisions which determine the authority for the host government to deal with privatization or which may restrict the implementation of privately financed infrastructure projects. In particular, problems relating to limitations to private ownership of land or infrastructure facilities are mentioned. It is underlined that uncertainties with regard to constitutional issues may delay implementation of projects or result in judicial disputes. Differences relating to privately financed infrastructure projects in different legal systems are discussed.

In the area of specific enabling legislation, the Guide discusses the pros and cons of more general legislation and of sector specific legislation, where uniformity of treatment and possibilities of taking into account the market structure for individual sectors are mentioned as factors to consider. Some core issues that may usefully be addressed by legislation are discussed, such as the legislative authority to grant concessions, the power of the host government to revoke or modify administrative contracts, issues relating to ownership and use of infrastructure, the power of state organs to regulate the provision of the services being privatized, administrative coordination of various governmental agencies being involved, regulatory procedures, and sanctions and appeals.

### 3. Chapter II — Project Risks and Government Support

Chapter II identifies the main categories of project risks and discusses contractual arrangements for risk allocation and mitigation. It also describes policy considerations relating to government support and various forms of government support. Finally, guarantees provided by financial instructions are discussed.

### 4. Chapter III — Selection of the Concessionaire

Chapter III deals in great detail with the selection procedures and methods. It takes the reader through all phases of the selection process from pre-qualification to project award.

The processes recommended incorporate many features from the UNCITRAL Model Law on Procurement of Goods, Construction, and Services. The Guide expresses a clear preference for the use of competitive selection procedures, rather than direct negotiations. This is in line with the advice of international organizations, e.g., the World Bank.

However, the Guide recognizes the complexities of the procurement of privately financed infrastructure projects and the variety of elements that are involved in projects. It also reflects the fact that costs could be very high for bidders. These factors lead to the acceptance of some special features, such as final negotiations with the proponent that has obtained the best rating and for contribution to the costs incurred by pre-qualified bidders.

In particular, the implications of the financial and operational responsibilities of the concessionaire are discussed. The fact that the legislation of some countries regards the privatization of infrastructure projects as a delegation of state power rather than a procurement process may find its way into the Guide.

### 5. Chapter IV — Construction and Operation of Infrastructure

The background of Chapter IV and Chapter V is that the legislation of many countries contains provisions on the mutual rights and obligations of the host government and the private parties and that problems may arise in relation to the extent to which such rights and obligations are made mandatory by legislation. Also, the need of at least some issues being resolved by the legislation is recognized. The Guide recommends that the legislative provisions are limited to certain matters, such as those for which legislative authorization is legally needed and those which may affect rights of third parties or which relate to essential policy matters.

Chapter IV discusses issues relating to the construction and operation of infrastructure and the need to cover such issues by legislation. Issues treated include, *inter alia*, review and approval of construction plans, variation in project terms, monitoring powers of the contracting authority, and duties of public service providers, such as continuity of service, equal treatment of customers and users, price controls, disclosure requirements, enforcement powers of the concessionaire, performance guarantees, and insurance.

### 6. Chapter V — Duration, Extension, and Termination of the Project Agreement

Chapter V addresses topics such as the duration of the project agreement, circumstances that may lead to an extension of such term, rights of termination, and consequences of termination in various situations.

### 7. Chapter VI — Governing Law

Chapter VI deals with the law governing the project agreement and the law governing contracts entered into by the concessionaire. It also identifies areas of legislation which are of relevance to privately financed infrastructure projects.

The importance of the existence of legislation that promotes private investment in general is underlined. Some selected aspects are pointed out, such as appropriate investment protection, adequate and modern property laws, possibilities of quick and efficient expropriation procedures, assurance of protection of intellectual property rights, a modern and unambiguous security law, an adequate and modern company law, modern accounting practices, a contract law that provides for flexibility and adequate remedies, a tax regime which is transparent, objective, and foreseeable, clear environmental protection laws and, finally a hospitable and internationally acceptable legal climate for the settlement of disputes.

Chapter VI is concluded with a reference to some international agreements which may impact privately financed infrastructure projects, such as agreements negotiated under the World Trade Organization.

### 8. Chapter VII — Settlement of Disputes

Chapter VII discusses disputes between the contracting authority and the concessionaire, disputes between the concessionaire and the lenders, disputes involving other parties and, finally, disagreements between the regulatory body and the concessionaire.

## E. CONCLUSION

As can be seen from the very ambitious scope and level of detail, the Guide, when finished, will no doubt be a very important contribution to the creation of the required legal environment for privately financed infrastructure projects, and thus to the promotion of such projects.

CHAPTER 3

# FOREIGN FINANCING OF INFRASTRUCTURE PROJECTS IN BRAZIL

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## A. INTRODUCTION

There are certain difficulties in the structuring of financing mechanisms for infrastructure projects in Brazil, most of which refer to stringent laws and Brazil's economic uncertainties. These difficulties, however, do not impede actual implementation of effective financing mechanisms, such as the securitization of receivables.

The financing of infrastructure projects in Brazil became of the utmost importance under the privatization spree during the last three years. Foreign investment in Brazil amounted to US $27 billion in 1999 alone, not to mention that the São Paulo Stock Exchange appreciated 159 per cent in local currency (approximately 72 per cent in United States dollars), which was by far the best performance worldwide.

Since 1991, when the Federal Privatization Program was launched, the proceeds obtained from privatization of public companies amount to approximately US $72 billion (US $27 billion from telecommunications only), while the debt transferred to private entities corresponds to another US $18 billion, totaling an economy of US $90 billion for the Brazilian government.

To explain the reasoning for such an increasing amount of foreign investment in Brazil, one would most certainly have a difficult time, given the complex fundamentals of the Brazilian economy and the fact that a number of legislative bills of taxation, pension, and administrative systems are still pending approval at National Congress.

However, despite all the above, foreign investors still find good reasons justifying investment decisions to their corporate boards headquartered abroad. Those reasons may have been difficult during early 1999 with the upheaval of the foreign exchange mechanism. Brazil now allows for the free floating of the local currency (which ultimately allowed for a hike in the inflation rate that came close to 10 per cent).

## B. EXCHANGE CONTROL AND EXCHANGE MARKETS

### 1. Background to the Exchange Control System

For a long time, Brazil adopted the so-called "official market" for exchange control, where the Central Bank of Brazil ultimately administered exchange rates. At first, the rates were established at a fixed level for long periods, but subsequently they were sharply devaluated, which caused the economy to have serious distortions.

This system was replaced by mini-devaluations in which the exchange rates varied daily to keep pace with inflation. Although suitable, this system did not prevent distortions, since daily-accrued devaluations were often lower than the inflation verified over a certain period, leading to maxi-devaluations.

### 2. History

On August 2, 1993, the *cruzeiro real* replaced the *cruzeiro* as the unit of Brazilian currency; each *cruzeiro real* being equal to 1,000 *cruzeiros*. In December 1993, the Brazilian government began implementation of the Real Plan, which was intended to reduce inflation. On July 1, 1994, the Real replaced the *cruzeiro real* as the unit of Brazilian currency, with each Real being equal to 2,750 *cruzeiros real* and having an exchange rate of R $1 to the US $1. According to Brazilian law, the issuance of Real is controlled by quantitative limits backed by a corresponding amount of United States Dollars in reserves, but the Brazilian government subsequently expanded those quantitative limits and allowed the Real to float, with parity between the Real and the United States Dollar (R $1 equal to US $1) as a ceiling.

On March 6, 1995, the Central Bank announced that it would intervene in the market and buy or sell United States Dollars, establishing a band (*faixa de flutuação*) in which the exchange rate between the Real and the United States Dollar could fluctuate. The Central Bank initially set the band with a floor of R $0.86 per US $1 and a ceiling of R $0.90 per US $1 and provided that, from and after May 2, 1995, the band would fluctuate between R $0.86 and R $0.98 per US $1. Shortly thereafter, the Central Bank issued a new directive providing that the band would be between R $0.88 and R $0.93 per US $1. On June 22, 1995, the Central Bank issued another directive providing that the band would be between R $0.91 and R $0.99 per US $1 and subsequently reset the band on January 30, 1996 to be between R $0.97 and R $1.06 per US $1.

Since then, the Central Bank has followed a policy of devaluing the Real in relation to the United States Dollar. On February 18, 1997, the Central Bank issued *Comunicado 5505* setting a new band of R $1.05 and R $1.14 per US $1. On January 15, 1999, the Brazilian government announced that it would no longer intervene to ensure that the Real traded within any given range of exchange rates, effectively adopting a floating exchange rate. The Central Bank subsequently announced that in limited circumstances it would intervene in the foreign exchange markets to curb excessive volatility.

The tourism exchange market was created in 1998 with rates that could be freely negotiated. Although this market was initially restricted to a few transactions, it represented a welcome major development, paving the way for other important changes in exchange regulations. In 1990, the official market was also authorized to adopt floating rates, becoming what is currently known as the commercial exchange market.

### 3. Types of Exchange Markets

There are presently in Brazil two exchange markets supervised by the Central Bank, both operating with rates that are freely negotiated between the parties:

(1) The free rate exchange market, also known as the commercial exchange market, which is mainly reserved for foreign trade, foreign investment, and foreign currency financing transactions previously approved by the Central Bank of Brazil. The basic characteristic of this market lies in the fact that each of its transactions requires a certain type of prior approval or registration with the Central Bank.

(2) The floating rate exchange market, also known as the tourism exchange market, which performs tourism-related transactions as well as several other transactions, whose processing is in line with applicable regulations. The basic feature of this market is that certain types or categories of transactions are authorized *a priori*, and do not require a specific authorization for each case, as verified in the commercial exchange market.

The scope of the tourism exchange market has been progressively widened so as to include new types of transactions. One example would be the possibility of using this market when making Brazilian investments overseas. When this is coupled with the express authorization to make international transfers in Brazilian currency, it clearly indicates the trend to make the Brazilian exchange policy increasingly more liberal. The monetary authorities have confirmed this trend on various occasions.

On January 25, 1999, the Brazilian government announced the unification of the exchange positions of the Brazilian banks in the floating market and the commercial market, which led to a convergence in the pricing and liquidity of both markets. The Brazilian government also allowed an increase in such positions to provide further liquidity to the foreign exchange markets.

It is worth mentioning that Brazilian law provides that, whenever there is a serious imbalance in Brazil's balance of payments or serious reasons to foresee such an imbalance, temporary restrictions may be imposed on remittances of foreign capital abroad as Brazil did when, to preserve Brazil's foreign currency reserves, the Brazilian government froze all dividend and capital repatriations that were owed to foreign equity investors, holding such funds at the Central Bank. These amounts were subsequently released in accordance with Brazilian government directives.

### 4. Interbank Exchange and International Transfers in Brazilian Currency

International transfers of Brazilian currency are allowed in the form of Central Bank's Circular.[1] A Brazilian party and non-resident, or resident abroad affects these transfers. The main features contained in the prevailing regulations are:

(1) The transfers are free and require no preliminary approval;

(2) Except in transfers of amounts of less than US $10,000, which can be made by a check, international transfers may be carried out only by a payment order, cashier's check (registered and not endorsed), or credit order document; and

(3) These international transfers must be registered every day with SISBACEN (the data-processing system of the Central Bank) by the bank from which the operation originated.

Accordingly, once a non-resident has received Real into its non-resident account, it may opt to remit these Real to a country where exchange of Real into foreign currency is freely made.

The exchange market regulations expressly allow interbank exchange transactions in any value without the need for specific authorization for each specific case, provided that such transactions are carried out by Brazilian banks and financial institutions offshore.

Since international transfers in Brazilian currency (from resident to non-resident or *vice versa*) were also allowed at the same time, the possibility of the following transactions arise:

(1) Transactions whereby Real are transferred by any resident or non-resident agent to a foreign financial institution;

(2) Transactions whereby the foreign financial institution would convert the Real received into foreign currency using the interbank exchange; and

(3) Transactions whereby foreign currency so obtained would then be turned over to the agent that initiated the transaction.

After many years under a totally controlled exchange system, the type of transactions described above may be viewed as somewhat unsettling, but nevertheless perfectly legal.

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[1] Central Bank Circular Number 2677/96.

In November 1993, the Central Bank published a brochure called *The Brazilian Exchange System — Recent Evolution and Perspectives*, which discusses the evolution of the exchange market in Brazil and explains various issues involved in international financial operations. This interesting brochure explains various points of relevance to the topic now being considered:

> To allow for the repatriation of capital under the floating-rate exchange market, the regulations permit institutions accredit by the Central Bank to purchase and sell foreign currency from financial institutions abroad, and to receive or turn over in return Brazilian legal tender (real). To implement this mechanism, it was necessary to have recourse to the provisions of a time-hallowed decree,[2] according to which "the entry and exit of both Brazilian and foreign paper currency are free, as well as the entry and exit of shares and any other instruments representing money". These entries and exists can occur by actual transport of the Brazilian and foreign paper currency in the pocket of the agents involved or — depending on the quantity-in packages, pouches, and so on, with the cash crossing the frontiers of Brazil with foreign countries. It would not, however, be operationally feasible for an institution accredited by the Central Bank in its day-to-day operations to fill money pouches with Brazilian currency and to send these pouches by courier to agencies of financial institutions offshore. It would be preferable for the foreign currency dealings with offshore financial institutions to be conducted through bank channels, by opening and operating Brazilian currency accounts with these financial institutions in banks here in Brazil. Moreover, in addition to facilitating such transactions, the operation of such accounts would be completely aboveboard, as there would be entries in the bank accounting records subject to Central Bank surveillance.[3]
>
> To further clarify the matter, on February 20, 1992, the Central Bank changed its standard accounting plan, including in the standard accounting an entry for Deposits of Those Domiciled Offshore, and a sub-account called Free Accounts — Financial Institutions — Floating — Rate Market. There were no restrictions on operation of this sub account, and it is not governed by the rules set forth in Letter Circular Number 5. The rules now prevailing for operation of Brazilian currency accounts for nonresidents are:
>
> (i) if the non-resident is an individual or legal entity but not a financial institution, the Brazilian currency balance of the current account can be used to purchase foreign exchange and to remit it abroad if — and only if — this Brazilian currency balance stems from foreign currency sold earlier by such party to a Brazilian bank; and
>
> (ii) if the non-resident is a financial institution, the Brazilian currency balance could be used to purchase and remit foreign exchange to overseas, without any restrictions whatsoever.
>
> The above means that if an agent should wish to make a remittance to offshore, it should deposit Brazilian currency in the account of a nonresident financial institution and allow the latter to do the rest. Using the Brazilian currency, it could purchase foreign exchange in a bank here in Brazil and transfer this

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[2] Decree Number 42820, December 16, 1957, article 17.

[3] Central Bank, *The Brazilian Exchange System — Recent Evolution and Perspectives*, November 1993, at pp. 13 and 14.

exchange to the overseas account of the beneficiary. The new system allows leeway for capital activities that is unprecedented here in Brazil.[4]

## C. DEBT OFFERINGS AND FOREIGN CURRENCY LOANS

### 1. Onshore Disbursement

Brazilian legislation sets forth the possibility of Brazilian companies' taking out loans or issuing debt securities on the offshore market in foreign currency for remittance to Brazil and immediate conversion into Brazilian currency, which would then become available to the borrower pursuant to an Act.[5]

Such transactions require preliminary approval from the Central Bank. Once this is obtained and normal fund disbursement occurs, the Central Bank, at the request of the Brazilian borrower, registers the transaction, and issues the certificate of registration, thereby allowing the Brazilian company to later remit overseas on the commercial and financial exchange market anything owed by way of principal, interest, and other charges.

To issue the certificate of registration, the Central Bank examines on a case-by-case basis the feasibility of the transactions proposed, taking into account the overall conditions of the transaction, such as, for instance, the minimum average repayment period, the interest rate, and the country's interest in having the transaction implemented.

Other than as discussed above, a Brazilian company cannot issue debt securities overseas or take out a foreign currency loan for in-country disbursement, as it would not be feasible for this company to make the exchange transaction necessary and to receive the corresponding funds in Brazilian currency.

### 2. Offshore Disbursement

There are no specific guidelines for a Brazilian company to take out a foreign currency loan or issue debt securities offshore for disbursement offshore. The fact that there are no guidelines does not, however, mean that this cannot be done. In our view, this type of transaction is legally feasible, but subject to the following consequences:

(1) Funds disbursed to the Brazilian company cannot be remitted to Brazil for closing of exchange on the commercial/financial market; and

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[4] Central Bank, *The Brazilian Exchange System — Recent Evolution and Perspectives*, November 1993, at pp. 16 and 17.

[5] Law Number 4131, September 3, 1962.

(2) Payments owed by the foreign creditor by way of principal, interest, and other charges cannot be remitted offshore on the commercial and financial exchange market.

Nothing, however, stands in the way of the Brazilian company's offering debt securities or taking out a loan in foreign currency for disbursement offshore, provided that it agrees:

(1) That the funds be brought into Brazil with the assistance of a non-resident financial institution, using the interbank exchange system and Brazilian currency international transfer;

(2) That the payments owed the offshore creditors by way of principal, interest, and other charges also be transferred offshore, using the interbank exchange system and Brazilian currency international transfer; and

(3) That the costs of the above be fixed on the basis of the exchange rate then prevailing on the tourism exchange market.

### 3. Permitted Issuers

Public or private non-financial institutions are not expressly allowed or prohibited from issuing debt securities abroad through the floating exchange rate market. However, this transaction is perfectly legal and viable through the mechanism described in section C. 2., above.

The Central Bank Resolution[6] allows financial institutions to borrow offshore through the commercial and financial market, with prior authorization of the Central Bank, for the specific purpose of on-lending the proceeds of such borrowing to companies in Brazil.

Central Bank Resolutions of July 1990 and July 1991[7] subsequently extend financial institutions' ability to raise funds abroad to the issuance of debt securities but for the purposes provided for in Resolution Number 63/67, i.e., the on-lending to companies in Brazil. The issue should be affected through the commercial and financial exchange market with the previous authorization of the Central Bank.

Bearing in mind that the raising of funds by financial institutions has a special purpose, as provided for in Resolution Number 63/67 and Resolution Number 63/67 mandates, that such a transaction be carried out via the commercial and financial

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[6] Central Bank Resolution Number 63, August 21, 1967.

[7] Central Bank Resolution Number 1734, July 31, 1990, and Central Bank Resolution, Number 1853, July 31, 1991.

exchange market. It is argued that it is not possible for financial institutions to issue debt securities on the tourism exchange market, even for the purpose of on-lending to companies in Brazil.

It is possible for a Brazilian company to offer debt securities or to take out a foreign currency loan offshore. Using the interbank exchange system and Brazilian currency international transfer, the Brazilian company can then transfer to Brazil the proceeds of the offshore debt offering or loan.

It is also possible for the Brazilian company to pay principal, interest, and other transaction charges using the same mechanism, through the tourism exchange market. It is not possible for financial institutions to issue debt securities through the tourism exchange market.

Finally, it is worth mentioning that depending on the conditions agreed, both direct foreign loan transactions and transactions involving the issue of securities abroad may enjoy tax benefits, characterized by a 100 per cent income tax reduction.

## D. PRIVATIZATION — FOREIGN FINANCING

Many years ago, Brazil initiated an intense privatization process by which a large number of public companies have been transferred to the private sector. Convinced that there is no reason to control non-essential activities, the government expects privatization bids to provide better quality and lower prices to the end consumer of goods and services related to such activities.

### 1. History

The privatization program in Brazil had a modest start. During the 1980's, the government did not have plans to implement a large-scale privatization program, which included in most cases companies which had been previously absorbed by the government due to their financial difficulties. Only 38 small-sized companies were privatized, and the proceeds were very modest (US $780 million). The main goal at that time was to keep the government from increasing its presence in the productive sector.

In the early 1990s, with the creation of the PND, privatization became an integral part of the economic reforms of the government. For that purpose, the magnitude and scope of the privatization process were expanded significantly.

In 1995, with the new administration entering into office, higher priority was placed on the privatization process. Privatizations were deemed to be one of the main instruments for the reform of the state and became an integral part of the then current administration. A new stage started, in which public service companies in the electricity, transportation, and telecommunications sectors were transferred to the private sector, with a view to improving the quality of the services provided to

the Brazilian public. At that time, the federal government also started to support the privatization process of companies controlled by the states of the federation.

In 1997, the privatization of the telecommunications sector began. Three concessions to operate cellular telephone services in three areas in Brazil were auctioned for US $4 billion. In July 1998, the federal government sold 12 holding companies created on the spin-off of the *Telebrás System*, which resulted in the transfer to the private sector of all the wireline and long-distance operators, as well as the "A" Band cellular operators. Total proceeds from the sale of the 12 companies totaled R $22 million, an average premium of 53.74 per cent over the minimum set auction price. In the electricity sector, control of the first generating company to be privatized, Centrais Elétricas Geradoras do Sul S.A. was sold for US $800 million.

In connection with state privatizations, in April 1999, a controlling stake in Companhia de Gás de São Paulo (Comgás) was purchased by British Gas for the sum of US $988 million, a premium of 119 per cent over the minimum set auction price. In July 1999, the State of São Paulo, the controlling stockholding, of Companhia de Geração de Energia Elétrica Paranapanema, a spin-off company from the generating company Companhia Energética de São Paulo — CESP, was acquired by Duke Energy for R $1.2 billion, which represented a premium of more than 90 per cent over the minimum price for the auction. The state government well succeeded once again when the controlling stake in Companhia de Geração de Energia Elétrica Tietê, another spin-off of CESP, was sold to AES, for R $938 million (a premium of 30 per cent over the set minimum price).

Companies which are privatized are taken over by the successful bidder in an "as is" standing, without the government making any representation as to their legal, tax, social security, or economic standing.

## 2. Costs and Financing

The acquisition, by the private sector, of public companies and of concessions for commercial exploitation of certain activities, however, entails enormous costs. These costs may be divided into immediate and post-privatization costs, as follows:

(1) Immediate costs are those directly related to the acquisition of the company or concession, and consist of payment of the stock purchase price or the concession price; and

(2) Post-privatization costs are those directly related to rescheduling of the debts assumed to face immediate costs with a view to retiming such debts and obtaining better payment conditions. Costs incurred with expansion and modernization of the relevant business — which is often a requirement made by the public authorities for the purchase of such business — may also be classified as post-privatization costs.

Post-privatization costs may be substantial. For companies that purchased concessions to exploit the "B band" wireless telephone system, e.g., these costs involve the entire implementation of the business, which is being developed from the beginning. In these cases, the immediate costs, which are quite high, involve only the acquisition of the concession.

The most frequently used form of obtaining financing for immediate costs has been the issuance of notes abroad, whether by Brazilian companies or by offshore subsidiaries of Brazilian companies, backed by their controlling companies. Bridge loans are also frequently used to meet immediate liquidity needs of Brazilian companies.

Although a practice often adopted is the issuances of notes abroad. However, this creates certain difficulties as a result of strict regulations, such as not very flexible terms and financial conditions, and difficulties in retiming or rescheduling the conditions agreed. The most commonly used structures for issuing notes abroad, devised to circumvent these difficulties, are:

(1) A foreign subsidiary of an offshore Brazilian company issues notes abroad backed by a Brazilian company. These issues usually have a term of one year; and

(2) The Brazilian company issues notes abroad, to be acquired by its offshore subsidiary, thus enabling the inflow of funds. This issue has a term of eight years, with a put option exercisable after one year. This structure opens several possibilities for rescheduling of debts abroad given that the offshore subsidiary is not subject to Central Bank control.

## E. PROJECT FINANCE

Project finance structures are defined as a financing scheme for a certain project, based on the expected cash flow of such project. This type of structure is often used to cover post-privatization costs of utility companies, and also to enable such companies to reschedule their debts.

When project finance structures were first used, infrastructure projects were financed mainly by foreign governments and multilateral development institutions, or through syndicated loan arrangements involving a group of commercial banks. Historically, these creditors required that the project investors guarantee the debt if the project was not completed or not in operation in accordance with certain specifications by a target date.

Today, international creditors and commercial banks agree to finance projects without demanding guarantees from equity investors. More and more creditors are financing projects through special purpose vehicles, especially projects with more developed and standardized technology, for which creditors may evaluate more accurately the risks and advantages involved.

The most recent change in the project finance area has been the opening of the United States capital market, as shown by the successful offer of project debt securities. Additionally, related entities have been increasingly used in project finance, particularly with regard to working capital and short-term financing made available by equity investors to the special purpose vehicle. The structuring of project finance by a concessionaire, however, must take into consideration certain legal and economic aspects.

The law applicable to project finance seeking foreign financing is very strict, and the entire structure is subject to exchange control rules and to the Concession Law, which limits considerably the possibility of structuring guarantees.

The economic aspects that should be taken into consideration include the economic uncertainties in Brazil, such as the risk relating to free currency conversion, excessive control of the concessionaires' operations and activities (tariffs, periodicity of adjustments, and impossibility of adjustments in the event of devaluation of the Real), and the performance risk of the concessionaire itself, whose activities may not be as successful as expected.

## F. CONCESSION LAW

Law Number 8987[8] provides for the regime of concession and permission to render public services. The rules set out in this law for granting of concessions are very strict and may impair implementation of a project finance transaction.

Some of the restrictions set out in the Concession Law are related to the possibility of transferring the concession, which is only allowed if expressly authorized by the Granting Authority, and the corporate control of the concessionaire. Furthermore, the bid documents must indicate the assets that will revert to the respective concession, namely, the assets that will revert to the granting authority at the time the concession expires, and also establish the use of such assets in the event the concession is extinguished.

As far as tariffs are concerned, the Concession Law replaces the remuneration guarantee system with the business risk. Therefore, definition of the tariffs must be included in the bid proceeding and respective contract, which may also set out mechanisms for tariff review and adjustment based on criteria that will take input costs into consideration in light of conditioning factors, such as the country's economic scenario, which are unrelated to the business risk inherent to the undertaking.

All project finance models involve, in a larger or smaller scale, the structuring of guarantees on assets in favor of investors. The basic concept established in the Concession Law regarding guarantee structuring is that the rights arising out of the

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[8] Concession Law Number 8987, February 13, 1995.

concession may be given in guarantee. However, this concept is very generic and therefore very difficult to carry out in practice.

Even considering the restrictions set out in the Concession Law, there are several manners of structuring guarantees for financing transactions relating to project finance models:

(1) Pledge of concessionaire's stock other than its controlling stock;

(2) Conditional pledge of the concessionaire's controlling stock. Any transfer of the concessionaire's controlling stock will be conditional on an authorization of the granting authority to such effect;

(3) Pledge of assets not defined as reversible; and

(4) Conditional pledge of assets defined as reversible. Any transfer of reversible assets will be conditional on an authorization of the granting authority to such effect.

It is worth mentioning that some of the guarantees listed above entail some difficulties, such as the conditional pledge or escrow which does not provide the level of security that is many times essential for investors in view of the requirement that an authorization from the granting authority be obtained for any transfer of stock and assets.

## G. SECURITIZATION OF RECEIVABLES IN PROJECT FINANCE STRUCTURES

Securitization of receivables consists basically of the use of future revenues, separated from the company that generated them, to back the issue of securities. These future revenues are usually called receivables.

The basic structure of a transaction for securitization of receivables may be described as follows:

(1) A utility company operating under a concession has credit rights derived from the core services provided by it;

(2) These credit rights are actually sold to a specific purpose company (SPC) especially organized for such purpose; and

(3) The SPC issues securities on the market, backed by credit rights, using the funds raised by issuing the securities to pay the concessionaire for the credit rights acquired.

The great advantage of this type of structure is the segregation of concessionaire-related risks, the matching of assets with liabilities, and the fact that it provides the concessionaire with a low fund-raising cost when compared with traditional forms of financing.

A common practice to provide an additional guarantee to investors is to hold in escrow the credit rights that back the issue of the SPC securities. Despite these advantages, securitization of receivables is a rather complex transaction that is costly and time-consuming, in addition to requiring disclosure of the concessionaire's contracts.

CHAPTER 4

# PROJECT FINANCING IN CANADA: PROJECT DEVELOPER AND FINANCING METHODS

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## A. INTRODUCTION

Project financing is the non-recourse or limited-recourse, high-leverage financing of the acquisition, development, construction, management, and operation of a specific project in which the method and availability of financing primarily depends on the revenues expected to be generated by, and the economic and technical viability of, the completed project, which is secured by the assets and undertaking pertaining to the project, on a going-concern basis, rather than the general credit and assets of the project developer.

The project developer or sponsor is a key participant in any project financing. Its track record, expertise, creditworthiness, and legal structure are important factors in assessing the viability of the project and determining the financing method.

## B. PROJECT DEVELOPER

### 1. Legal Structures

In Canada, a variety of legal structures may be used to constitute the project developer. They include co-ownership, partnership, and corporation. The project developer is usually structured as a "special purpose vehicle", to insulate it from obligations and liabilities unrelated to the project. These structures, together with a more specific type of corporation, e.g., the Nova Scotia Unlimited Liability Company, will be discussed.

There is no structure that can be used or considered as the perfect solution for every case. Consideration must be given as to which structure is the most appropriate in each instance.

## 2. Co-Ownership

### a. *General*

Co-ownership exists when two or more persons (whether individuals or legal entities) own property jointly as an investment, i.e., purchase, hold, and re-sale the property, without using the property for the purpose of carrying on business in common with a view to profit.[1]

### b. *Advantages*

In a co-ownership, unlike in a partnership, each co-owner continues to own and is able to deal with its interest in the co-owned property in a separate and different manner than the other co-owners. As such, a co-owner can sell its interest in such a property to a third party, or claim capital cost allowance (tax depreciation) based on its interest in such property, at a time and on a basis different from that of the other co-owners, subject to the terms of any co-ownership agreement.

This may prove to be very important in project financing where, at the end of a fiscal year, some of the participants have taxable income while others have losses, as a result of their other separate activities. Those with taxable income will be able to claim capital cost allowance to reduce their tax liability by reducing their income, while those with losses will defer such claim until a year with taxable income.

Unlike partnerships, co-owners are not agents for each other, and the acts of one co-owner do not bind other co-owners, except as otherwise agreed to in the co-ownership agreement.

If a partnership relationship is to be avoided, for tax reasons, it is prudent to separate the ownership and management functions by placing them in separate legal structures or entities, i.e., ownership held in co-ownership, and development, construction, operation, and management carried out through a partnership or corporation.

### c. *Disadvantages*

The fact that co-owners are not agents of each other can also be a disadvantage, particularly when a business project is undertaken. In such a case, the participants may prefer to adopt one of the following legal structures.

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[1] Although the Ontario Partnerships Act, R.S.O. 1990, chapter P 5, section 3, provides that joint property in itself does not create a partnership; even if the co-owners share in the profits generated by the property held in co-ownership, a co-ownership agreement should be drafted carefully to ensure that the co-ownership does not become a partnership.

### 3. Partnership

#### a. *General*

When two or more persons (whether individuals or legal entities) carry on business together with a view to profit, the relationship is called a partnership and the members of the partnership are called partners.

Since partnerships are not separate legal entities from their partners, they are not taxpayers for Canadian tax purposes. Partnerships are, essentially, flow-through legal structures computing income or loss for tax purposes to be subsequently allocated proportionally to each of the partners who will then be taxed individually. In other words, the income or loss resulting from the partnership business is calculated at the partnership level, but is taxed in the hands of the partners. For the same reason, partnerships do not pay capital tax; however, their corporate partners are allocated their proportionate share of partnership assets and liabilities to calculate their respective capital tax.

In Canada, two types of partnerships can be constituted: the general partnership, simply called partnership, and the limited partnership.

#### b. *General Partnership*

I. **General.** A general partnership is constituted by an agreement to carry on business in common and to share profits on the basis determined in the partnership agreement or on equal basis, if there is no such agreement.

In a general partnership, all partners are agents of each other within the scope of the partnership business. Most importantly, and unlike a limited partnership or corporation, each partner is personally liable to the extent of its assets, jointly with the other partners, for all debts and other obligations of the partnership incurred while a partner.

The property contributed by the partners to the partnership, or purchased in the course of the partnership business, is called "partnership property". It is the property of the partnership, and the partners do not have a direct interest in it (title to the partnership property is held either jointly by the partners or by one or more partners in trust for the others). A partner is not entitled to a portion of the partnership property itself. Rather, on dissolution of the partnership, a partner is entitled to the sale of the partnership property and the division of the proceeds, after the discharge of all liabilities of the partnership. Otherwise, if a partner desires to sell its interest, it must be sold as an interest in the partnership, not in the partnership property.

II. **Advantages.** Partnerships, unlike co-ownerships, can be used to develop and operate a property and not simply to hold such property as an investment. The majority rule that generally governs partnerships makes them a more effective vehicle than a co-ownership structure in terms of decision-making.

A partner may transfer property to a partnership, consisting of Canadian residents, on a tax-deferred basis. Partnerships, as opposed to corporations, are not subject to capital tax. The fact that partnerships are, from a tax perspective, a flow-through of income or loss to the partners, may provide a significant advantage in a project financing situation since it may enable the participants to lower their income by applying losses incurred during the development and construction phase against other revenues, thus reducing their tax liability.

**III. Disadvantages.** Partners are subject to personal unlimited liability for the debts of the partnership, as opposed to limited partners or shareholders. However, this disadvantage may be dealt with by ensuring that the partnership interest is held through a limited partnership or corporation so as to limit the ultimate exposure to the equity participation in such limited partnership or corporation.

Capital cost allowance and other tax deductions can only be claimed at partnership level and not independently by the partners. Thus, the partners must agree on whether to make such a claim, at partnership level, and on the amount to claim. It is only the resulting income or loss that is subsequently included in each partner's income calculation for income tax purposes.

*c. Limited Partnership*

**I. General.** A limited partnership is constituted of one or more limited partners and one or more general partners. A limited partner is basically a passive investor rather than an active participant in the operation of the limited partnership, and may contribute money or property to the limited partnership. A general partner has all the rights and powers, and is subject to all the restrictions and liabilities, of a partner in a general partnership.

In Ontario, a limited partnership is formed when a declaration is filed pursuant to the Ontario Limited Partnerships Act.[2] While limited partnerships provide advantages similar to those available under a general partnership, some differences should be noted.

**II. Advantages.** The principal advantage of limited partnerships is that the liability of each limited partner is restricted to the amount of money or other property that the limited partner contributes, or agrees to contribute, to the limited partnership. From a tax perspective, the advantages provided by a general partnership are, with some adaptations, applicable to limited partnerships.

**III. Disadvantages.** A limited partner must accept a passive investor role, since it may become liable as a general partner if it takes part in the control of the business of the limited partnership.[3]

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[2] Ontario Partnerships Act, R.S.O. 1990, chapter P5, section 3.

[3] Ontario Partnerships Act, R.S.O. 1990, section 13.

The amount that a limited partner has contributed to the partnership will determine the share of the losses that the limited partner will be entitled to claim for tax purposes.

### 4. Corporation

#### *a. General*

Unlike the business structures already discussed, a corporation is a legal entity separate in law from its owners, the shareholders of the corporation. Creditors of a corporation may demand to be repaid from the assets of the corporation, but cannot demand (except in the rare cases where the "corporate veil" is lifted, such as when the corporate structure has been used for illegal purposes) that the balance of the unpaid liabilities of the corporation be paid by its shareholders.

The income or loss of a corporation is calculated and taxed at the level of the corporation, separately from its shareholders' tax on income. As a result, corporations cannot flow out losses to their shareholders. Corporations are taxpayers for Canadian tax purposes and are also subject to capital tax.

Carrying on business in Canada through a corporation can be accomplished, among other means, by establishing a branch or by incorporating a subsidiary.

#### *b. Branch*

**I. General.** A foreign corporation may carry on business in Canada by establishing a branch, provided that it obtains the applicable extra-provincial license from the appropriate government office.

**II. Advantages.** A major advantage in using a branch in Canada is to allow losses of such branch operation to be offset against income in the foreign corporation's jurisdiction of residence, provided it is allowed by the tax laws in the jurisdiction.

The establishment of a branch, as opposed to the incorporation of a subsidiary, would also allow a foreign corporation to avoid the application of the "thin capitalization rules" on interest deductibility. These rules, which only apply to Canadian resident corporations, restrict the amount of deductible interest on debts owing by such corporations to, essentially, non-resident shareholders that exceed a three-to-one debt to equity ratio. As a result, doing business in Canada through a branch allows a foreign corporation to use more interest-bearing debt from its shareholders to finance the Canadian operation, without losing deductibility of interest, than if the Canadian operation would have been carried out through a subsidiary.

**III. Disadvantages.** A tax of 25 per cent on after-tax earnings (branch tax) is generally imposed on foreign corporations doing business in Canada through a branch operation, irrespective of whether such earnings are distributed or retained

in Canada, unless such earnings are reinvested in the operation of the branch in Canada. This 25 per cent rate has in some cases been reduced by tax treaty.

Another disadvantage of using a branch, as opposed to a subsidiary, is that the foreign corporation is not "insulated" against liabilities incurred by the branch operation in Canada.

*c. Subsidiary*

**I. General.** A Canadian subsidiary may be incorporated as a federal corporation under the federal laws of Canada or as a provincial corporation under the laws of one of the provinces.

In general, a federal or provincial corporation that does not offer its securities to the public is not required to have more than one director. However, a majority of the directors must be "resident Canadians". A "unanimous shareholder agreement" by all the shareholders can remove from the directors of the corporation all or part of the general powers vested in the directors to manage the business and affairs of the corporation, and vest such powers and corresponding liabilities in the shareholders themselves.

Thus, while a majority of the directors must be resident Canadians, the business and affairs of the Canadian subsidiary can be controlled by the non-resident shareholders rather than by the directors.

**II. Advantages.** Carrying on business through a Canadian subsidiary will insulate the foreign parent corporation from the liabilities of the Canadian operation.

While the branch tax is applicable once earnings are realized by a branch operation in Canada (unless, in general terms, such earnings are reinvested in the operation of the branch), the Canadian subsidiary's after-tax earnings are only subject to tax, in the form of withholding tax, if, and only in the year when, such earnings are distributed by the subsidiary to its foreign parent corporation.

It may also be advantageous for a foreign corporation to incorporate a subsidiary in Canada rather than to open a branch, when the tax rate in the foreign corporation's jurisdiction for the income derived from its Canadian operation is higher than the Canadian rate for the same type of income.

**III. Disadvantages.** Using a subsidiary will prevent the flow-through of losses from the Canadian operation to the foreign parent corporation. Accordingly, it might be preferable to use a partnership or branch when several years of losses are anticipated during the initial phase of the project. In the case of a partnership, partners, unlike shareholders, can deduct their share of losses from the partnership against other income. In the case of a branch, the losses of the Canadian operation are losses of the foreign corporation which may apply them to reduce its income, and thereby its tax liability, in the foreign jurisdiction.

After-tax earnings distributed by a subsidiary of a foreign corporation to its parent are subject to a withholding tax of 25 per cent. This rate is, however, reduced in many cases by treaty. For example, under the Canada–United States tax treaty, the withholding tax on dividends paid by the Canadian subsidiary to its United States parent is reduced to five per cent.

The thin capitalization rules, which restrict the amount of deductible interest from debts owing to specified non-residents that would otherwise be deductible, apply to a subsidiary of a foreign corporation, but not to a branch operation.

*d. Nova Scotia Unlimited Liability Company*

**I. General.** The Nova Scotia unlimited liability company is created under the Nova Scotia Companies Act.[4] Its principal feature is the unlimited liability of its shareholders, who are personally liable for all the debts incurred by the Nova Scotia unlimited liability company.

From a Canadian tax perspective, it has been ruled by Revenue Canada that a Nova Scotia unlimited liability company is a corporation for the purposes of the Income Tax Act (Canada) and thus is subject to tax in the same manner as any other Canadian corporation.[5]

In the United States, the "check-the-box" regulations that were issued by the Internal Revenue Service on December 17, 1996 provide that a foreign entity whose members do not have limited liability will automatically qualify as a partnership.

Since a Nova Scotia unlimited liability company can be treated as a corporation in Canada and as a foreign partnership in the United States, if properly structured, a Nova Scotia unlimited liability company may be used in the context of project financing to provide a United States investor-participant with corporate treatment in Canada while allowing for partnership treatment, i.e., the flow-through of income or losses, in the United States.

**II. Advantages.** The principal advantage of a Nova Scotia unlimited liability company is to allow the flow-through of income or losses of the Canadian business operated by the Nova Scotia unlimited liability company to the United States shareholder who qualifies in the United States for partnership taxation treatment, but with limited liability, such as when the shares of the Nova Scotia unlimited liability company are held through a limited partnership, a sub-chapter S corporation, or a limited liability corporation. Such a flow-through is impossible between a subsidiary and its parent.

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4 Companies Act, R.S.N.S. 1989, chapter 81, as amended.

5 Income Tax Act, R.S.C. 1985, 5th Supplement.

There are no Canadian residency requirements for the directors of a Nova Scotia unlimited liability company.

**III. Disadvantages.** In addition, the creation of a Nova Scotia unlimited liability company will trigger the application of the Canadian thin capitalization rules, which, as already mentioned, do not apply with respect to a branch.

The unlimited liability aspect of a Nova Scotia unlimited liability company might be a concern. However, while the Nova Scotia unlimited liability company's creditors have no limit on their claim against the Nova Scotia unlimited liability company's shareholders on the dissolution of the Nova Scotia unlimited liability company, the ultimate investors' exposure may be limited by using a limited partnership or limited liability corporation for the purpose of holding the shares of the Nova Scotia unlimited liability company.

In such a case, even if the Nova Scotia unlimited liability company's creditors exercise their claims against the Nova Scotia unlimited liability company's shareholders, the ultimate investors will not risk losing more than their investment in the limited partnership or limited liability company.

## 5. Summary

The above presentation of the forms of business is only an overview, and other forms of business organizations are also available.

In a co-ownership, each owner continues to own and is able to deal with its interest in the co-owned property. This liberty allows each co-owner to use its own tax deductions as it sees fit.

Two kinds of partnerships have been addressed: general partnerships and limited partnerships. One of the principal features of a general partnership is that each partner is liable with the others to the full extent of its personal assets for all debts and obligations of the partnership. However, the creation of a limited partnership allows the limited partners to restrict their liability to the amount contributed. Partnerships allow a flow-through of income and losses to the partners, including their pro rata portion of such income or loss in the calculation of their income for tax purposes.

A foreign corporation may open a branch operation or incorporate a subsidiary in Canada. A branch allows losses of such branch operation to be setoff against income in the foreign jurisdiction. A subsidiary may be used to insulate the foreign parent from liability resulting from the Canadian operation or when the tax rate in the foreign corporation's jurisdiction for its Canadian activities is higher than the Canadian rate.

A Nova Scotia unlimited liability company may be particularly attractive to United States investors since it can be treated as a corporation in Canada and as a foreign partnership in the United States, therefore providing significant tax advantages.

## C. FINANCING METHODS

### 1. Background

Project financing is usually structured in two interrelated phases: the development and construction phase of the project, typically financed by a short-term loan secured on the assets pertaining to the project, and the management and operation phase, with respect to which the construction loan, which is due on satisfactory completion of the construction, is replaced by the permanent "take-out" financing. The permanent financing may take various forms and use various financial instruments and techniques, including equity, secured debt, and lease financing, or a combination of them.

In selecting the financing method, the project developer's goals will be to eliminate or limit the risk of having its own credit and assets exposed to recourse by the financing providers and thereby to reduce the financing cost. Thus, to the extent accommodated by the participating investors, lenders, or lessors, the project developer will want financing to:

(1) Be "non-recourse", i.e., that the financing is serviced only by the project revenues and is secured by the assets and undertaking pertaining to the project, on a going-concern basis, and the developer is not responsible for the shortfall if such revenues are insufficient to service the financing;

(2) Maximize leverage by financing most of the development and construction cost;

(3) Be "off-balance sheet";

(4) Maximize tax benefits, such as tax depreciation, credits, and losses; and

(5) Avoid withholding tax on "cross-border" outbound payments of rent or interest.

### 2. Equity

#### *a. General*

Most project financing structures involve an equity component, whether as an active or passive investment. Equity investors usually participate in the financing through partnership interests or shareholdings in the project developer.

The choice of the investment vehicle is usually driven by liability and tax considerations. Equity is usually required during the development and construction phase of the project or at financial closing. Equity facilitates the obtaining of debt financing by the developer-borrower by, *inter alia*, reducing its debt to equity ratio.

*b. Investor Objectives*

The equity investors' primary objective is the economic and technical viability of the project to justify their participation as equity investors (with the inherent risk of losing the investment, but also with the "upside" of the increase in the value of their equity investment in the project developer) as opposed to being creditors or lenders.

They will require that maintenance and operation expenses and debt service be paid by the project developer as scheduled, and that project expenses stay within budget. To monitor these objectives, equity investors will usually require in a subscription agreement that all major decisions regarding the project be subject to their consent. Unlike lenders, equity investors will favor events of default more limited in scope, and will require the option (without obligation) to cure the default and, as a result, the right to be subrogated to the lenders.

## 3. Debt

*a. In General*

Lenders participate through senior and, sometimes, subordinate loans. The senior loan agreement usually includes a short-term construction loan which, on completion of the construction and satisfaction of certain conditions precedent (such as operation of the project at pre-determined performance levels) converts into a long-term loan for the management and operation phase of the project. Sometimes, the short and long-term loans are subject to separate agreements with different lenders. In this case, the short-term loan becomes due on such satisfactory completion of the construction, at which time it is replaced by the long-term or permanent financing.

The objectives of the subordinate lenders are fundamentally the same as those of the senior lenders, except that their rights of repayment and rights under the security agreements are subordinated to those of the senior lenders.

The respective rights of the senior and subordinate lenders, and especially their rights with respect to calling the project developer in default and exercising remedies against it and the collateral securing their loans, are usually set out in an inter-creditor agreement.

To secure the repayment of their loans by the project developer, the senior and subordinate lenders will require, from the project developer, security agreements which usually include:

(1) A conditional assignment of all revenues, contracts, bank accounts, insurance proceeds and, to the extent permitted by law, governmental permits and authorizations pertaining to the project, i.e., the assignment

is not an immediate conveyance or transfer, and becomes effective only when the project developer is called in default;

(2) A charge (mortgage in Canadian Common Law provinces or *hypothec* in Canadian Civil Law) on all real and immovable properties pertaining to the project;

(3) A charge (security interest in Canadian Common Law provinces or *hypothec* in Canadian Civil Law) on all personal and movable properties pertaining to the project; and

(4) A pledge of all the issued and outstanding shares of, or partnership interests in, the project developer.

To avoid withholding tax on the interest paid by the project developer to non-residents on such loans, the loan agreement should stipulate that the project developer cannot be obliged to repay more than 25 per cent of the principal amount of the balance of the loan within five years from the date of the loan agreement, except where such repayment is made pursuant to pre-agreed events of default.

*b. Lender Objectives*

The lenders' main objective is to ensure that the economic and technical viability of the project is sufficient to support the loan extended to the project developer. Like equity investors, they will require that maintenance and operation expenses be paid by the project developer as scheduled, and that project expenses stay within budget. To monitor such objectives, lenders will require, usually as part of the negative covenants in the loan agreement, that no major decision regarding the project be taken without their consent. Unlike equity investors, lenders will favor a wider range of events of default, including, most likely, cross defaults with other significant project agreements, such as the subordinated loan, security agreements, equipment lease, and product "off-take" agreement.

The purpose of the security agreements is to enable the secured lenders, in the event the project developer defaults under the loan, to exercise their remedies against the charged property (essentially all the assets and undertaking pertaining to the project as a going concern) by selling or, if permitted by law, retaining it in full satisfaction of the debt, or to take control of the project developer through the pledged shares or partnership interests.

*c. Non-Resident-Owned Investment Corporation*

I. **General.** A non-resident-owned investment corporation is a Canadian corporation owned by non-resident shareholders that is taxed as if it were a non-resident corporation situated in the jurisdiction of the residence of its shareholders. A non-resident-owned investment corporation pays federal tax at the rate of 25 per cent of its taxable income, such tax being refundable when the corporation

distributes its income as dividends to its shareholders, at the rate of Cdn. $1 of refund for every Cdn. $ 4 of taxable dividends paid. This refund is subject to a one-year time lag between the payment of the 25 per cent tax and the entitlement to a refund. The tax so paid is credited to a notional account referred to as "allowable refundable tax on hand".

In general terms, in order for a corporation to be taxed as a non-resident-owned investment corporation, all its shares and debt instruments must be beneficially owned by non-residents of Canada (other than a foreign affiliate of a taxpayer resident in Canada); its principal business in any taxation year may not be the making of loans or trading or dealing in securities, and it must elect in a prescribed manner to be taxed as a non-resident-owned investment corporation not later than 90 days after the date of its incorporation.

**II. Objectives.** A non-resident-owned investment corporation structure may be used to "double dip" on borrowing costs by creating the possibility of a deduction for such costs both by the foreign parent corporation (ForeignCo) and a Canadian wholly owned subsidiary (being the project developer). This wholly owned subsidiary will be an affiliate of the non-resident-owned investment corporation.

Such a structure will involve the incorporation by ForeignCo of two wholly owned subsidiaries in Canada: one will be the project developer (DevCo) and the other the non-resident-owned investment corporation.

ForeignCo will borrow funds from an unrelated financial institution in its jurisdiction of residence, sufficient to finance the participation of DevCo in a given project.

ForeignCo will then subscribe for all the shares of DevCo by using a portion of such borrowed funds. Such equity investment in DevCo should not be less than 25 per cent of the cost of the proposed DevCo investment in the project, to comply with the thin capitalization rules restricting the amount of deductible interest on debts owing to specified non-residents, discussed earlier in this chapter.

The balance, i.e., up to 75 per cent, of the funds necessary to complete the proposed project investment by DevCo will be used by ForeignCo to subscribe for all the non-resident-owned investment corporation shares. The non-resident-owned investment corporation will, in turn, lend such funds to DevCo at a market rate of interest and subject to customary repayment terms.

DevCo will use ForeignCo's equity investment in its share capital and the non-resident-owned investment corporation loan to complete the proposed project investment.

The interest payable by DevCo to the non-resident-owned investment corporation will constitute the non-resident-owned investment corporation's taxable income and be subject to a 25 per cent refundable tax for the first taxation year of the

non-resident-owned investment corporation. Since such tax is refundable when the non-resident-owned investment corporation distributes its income as dividends to ForeignCo (which will attract withholding tax), the non-resident-owned investment corporation will not need, after its first taxation year, to make further payments of tax on its income (assuming its income will not vary), but will have an amount equal to the tax paid in respect of its first taxation year indefinitely allocated to its "allowable refundable tax on hand" account.

The principal advantage of this structure is the possibility of a "double-dip" deduction for borrowing costs both by ForeignCo and DevCo. This "double dip" is possible since ForeignCo will deduct the interest on its borrowing in the foreign jurisdiction while DevCo will also deduct interest in Canada on its borrowing from the non-resident-owned investment corporation.

### 4. Lease Financing

#### a. *General*

In general terms, equipment lease financing in Canada is concerned with two issues: the availability of capital cost allowance, i.e., tax depreciation, and the avoidance of withholding tax on outbound cross-border leases.

The Canadian tax system limits the tax depreciation that a lessor may claim to the amount of income derived from the leasing property, unless the lessor's principal business is that of leasing. Where the leased property is "specified leasing property", such tax depreciation is further limited by the application of the so-called "specified leasing property rules" to the portion of the rent which would be principal if the lease were reconfigured as a notional loan from the lessor to the lessee in a principal amount equal to the fair market value of the leased property, bearing interest at a prescribed rate, with the rental payments being deemed to be blended payments of principal and interest on such loan.

Under the Canadian Income Tax Act, "specified leasing property" is essentially any depreciable property subject to a lease with a term of more than one year and which has a cost in excess of Cdn. $ 25,000, other than certain intangible property and "exempt property".[6] Exempt property includes general purpose office furniture or equipment, general purpose electronics data processing equipment having a cost of not more than CDN$ 1-million, certain light and medium duty trucks, tractors or trucks used for hauling freight on highways, trailers for holding freight that are designed to be hauled by such trucks or tractors, rail cars, and buildings and component parts.

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[6] Income Tax Act, R.S.C. 1985, 5th Supplement.

In the first year in which the specified leasing property is acquired, a lessor may only claim one-half of the amount of tax depreciation that would otherwise be allowed (unless the lessor's principal business is that of leasing).

Generally speaking, the specified leasing property rules apply only to the lessor. However, under the Income Tax Act, section 16.1, a lessee and an arm's length lessor who is not a tax exempt entity, are allowed to file a joint election to treat leased property that is specified leasing property as an asset purchased by the lessee. Where such an election is made, the lessee is deemed to have purchased the leased property at a cost equal to its fair market value and to have financed such purchase by borrowing from the lessor an amount of money equal to such fair market value. Since the lessee can treat the lease as a purchase, the fair market value of the leased property is added to the lessee's capital cost allowance pool and the lessee can claim tax depreciation on such property instead of deducting the lease payments as current expenses.

The rental payments are deemed to be blended payments of principal and interest, with the interest component being deductible as long as the leased property is used for an appropriate business purpose. At the termination of the lease, the lessee is deemed to have sold the leased property for proceeds equal to its deemed cost, i.e., fair market value at the time of the election, less the aggregate of the deemed principal payments. The lessor's tax position is not affected by such election.

The other key issue in equipment lease financing in Canada is the withholding tax on outbound rent where "cross-border" structures are involved. In general, Canada applies withholding tax to payments of rent (also interest, dividends, royalties, and similar payments for the use or right to use any property in Canada, with certain exceptions) made by Canadian residents to non-residents. The most important exception is that for rent paid to non-residents for the use or right to use aircraft or aircraft parts in Canada, or for the use or right to use any property outside Canada only. Neither of these exceptions applies in the context of project financing in Canada.

As a result of the withholding tax on lease payments (at the rate of 25 per cent of the lease payment, unless the rate is reduced by treaty), inbound cross-border equipment leases (other than for aircraft and aircraft parts) must be structured so as to avoid such withholding tax.

### *b. Objectives*

The main objective of equipment lease financing in a project financing context is to enable the project developer, as lessee, to finance the use and, ultimately, the acquisition of the leased equipment on a non-recourse, highly (if not totally) leveraged and off-balance sheet basis, and to reduce the cost of such financing by "sharing in" the tax advantage received by the lessor in the form of tax depreciation.

Since the tax depreciation which a Canadian resident lessor may claim in a domestic equipment lease financing is limited by the "specified leasing property" rules and as an Income Tax Act, section 16.1, election is not available in circumstances where the lessor is a tax exempt entity (thus limiting the amount of, and entitlement to share the tax depreciation available to reduce the cost of equipment financing), a Canadian resident developer-lessee may favor entering into a crossborder lease financing of the equipment required for the project.

In the context of project financing, the outbound rental payments under a cross-border equipment lease financing will be subject to withholding taxes. To avoid such withholding taxes, the transaction is usually restructured as a lease for the lessor, under the laws of its jurisdiction, and a conditional sale, i.e., ownership in the equipment will not pass until paid in full, for the lessee (being the project developer) under the laws of its Canadian jurisdiction. In other words, the same transaction will have to receive different legal characterizations in the jurisdictions of the lessor and the lessee.

The advantage of such a structure is that, in addition to avoiding withholding tax, if properly structured, it may allow for a "double dip" on tax depreciation by enabling both the lessor and the lessee to claim separately, in their respective jurisdictions, tax depreciation on the equipment subject to such transaction.

Several factors are usually considered by Canadian Courts in determining whether a transaction should be characterized as a lease or conditional sale, such as the purchase option price, the transfer to the lessee of the incidents of ownership, and the lease term exceeding the economic useful life of the equipment. The factor considered determinative is the equipment purchase option price. The test, as developed by Canadian courts, is whether the purchase option, considered at the beginning of the lease, is at a price such that no reasonable person would fail to exercise it, i.e., the parties must have necessarily contemplated, from the beginning of the lease, that the equipment will be transferred to the lessee on expiration of the lease. This will clearly be the case where the purchase option price is only nominal or substantially less than the probable fair market value of the equipment at the time the option is exercisable.

The installment payments under such conditional sale will have to clearly identify the principal and interest portions and, to avoid withholding tax on such interest, the agreement should stipulate that the lessee/conditional purchaser cannot be obliged to repay more than 25 per cent of the principal amount of the balance of the purchase price within five years from the date of the agreement, except where such repayment is made pursuant to pre-agreed events of default. Several tax treaties to which Canada is a party provide for withholding tax exemption for interest paid in connection with a "sale on credit" (possibly including conditional sales) of equipment, merchandise, or services, where the parties deal at arm's length.

Whether such equipment financing is structured as a lease or conditional sale, the lessor or conditional vendor will require that the payment of the lease rentals or conditional sale installments (and the performance of other obligations under the

lease or conditional sale) be secured against the equipment and its proceeds (including insurance and replacement equipment) as collateral.

In the Canadian Common Law provinces, such an equipment lease or conditional sale will usually constitute a security interest in such collateral or, sometimes, a separate security agreement is entered into for such purpose, pursuant to the applicable personal property security legislation.

In the province of Quebec, the Civil Code equivalent of such personal property security will be an installment sale (conditional sale agreement), leasing (*crédit-bail*) or lease for a term in excess of one year, pursuant to which the reservation of ownership of the conditional vendor, the right of ownership of the lessor under the leasing (*crédit-bail*) or the right of the lessor resulting from such long-term lease, as applicable, is opposable against third parties only if it has been registered in the prescribed manner.

## 5. Conclusion

The above discussion on financing methods is only an overview of selected methods available in Canada in the context of project financing. The project developer will want the financing to be non-recourse, highly leveraged, and off-balance sheet, and will also want to maximize tax benefits and avoid withholding tax on "cross-border" outbound payments.

Equity investors, lenders, and financial lessors will want to ensure the viability of the project from an economic and technical standpoint. Lenders will insist on having the ability to take possession of and realize all the assets and undertaking pertaining to the project, and to operate the project, and for such purpose they will require security on all such property and a pledge of all the ownership interest (shareholdings or partnership interests) in the project developer.

A non-resident-owned investment corporation structure may be used by a non-resident corporation to achieve a "double-dip" deduction of the costs incurred by such foreign corporation and its wholly owned subsidiary in Canada in borrowing funds for the purpose of such wholly owned subsidiary's participation in the project.

Tax-based lease financing may be used to enable a Canadian resident project developer to reduce its cost of financing the use and acquisition of equipment required for the project. If such lease financing is domestic, the lessor (which is not a tax-exempt entity) and developer-lessee may elect to treat the leased equipment as equipment purchased by the developer-lessee, so as to enable the developer-lessee to claim tax depreciation on such equipment. If such lease financing is "cross-border", the Canadian portion should be structured so as to permit its characterization in Canada as a conditional sale to avoid withholding taxes on outbound rental payments.[7]

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[7] The author acknowledges the contribution of Félix Duval, articling student, in assisting with the research for and preparation of the section on Project Developer in this chapter.

CHAPTER 5

# THE COLOMBIAN POWER SECTOR — PROJECT FINANCE AND INVESTMENT

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## A. KEY CHARACTERISTICS OF THE COLOMBIAN POWER SECTOR

Until 1991, Colombia's electricity sector was formed by state-owned, vertically integrated companies. Since then, privatization and private capitalization of state-owned companies have reshaped the industry. The change began with the new Constitution in 1991, further developed by Law 142 and Law 143 of 1994.

### 1. Legal Framework

Law 142 of 1994 (Public Utilities Law) establishes the legal framework for the rendering of domiciliary public services and related activities. Energy distribution is a domiciliary public service, and its related activities are generation, interconnection, transmission, and trading of electricity.

Law 143 of 1994 (Electricity Law) governs the generation, interconnection, transmission, distribution, and trading of electricity, and it designates the government entities in charged of the regulation, planning, operation, and expansion of the electricity sector.

The environmental legal framework is set forth in Law 99 of 1993 and in several regulatory decrees. Particular importance must be given to the provisions regarding the environmental license,[1] which must be obtained by any agent planning to build a generation plant. If the generation plant has a capacity of more than 100 MW, the competent authority for issuing the environmental license is the Ministry of the Environment. In addition, Law 99 of 1993[2] imposes a compulsory transfer of certain sums on generators in favor of the municipalities and the regional environmental agencies known as Corporaciones Autónomas Regionales. In the

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[1] Law 99/93, articles 49–62; Regulatory Decree 1753 of 1994.

[2] Law 99/93, article 45.

case of thermal plants, the total transfer is equal to four per cent of the gross sales of energy calculated on the basis of a reference price set by CREG (as defined below) for such purposes.

## 2. Government Authorities

Under the Electricity Law, the government has the role of promoting competition, preventing abusive practices, protecting consumer rights, broadening the coverage of the service to all regions, satisfying the demand for electricity, and assuring the efficient, reliable, and safe operation of the system.

The particular government entities that have a bearing on the electricity sector are the following:

(1) The Regulatory Commission for Energy and Gas Affairs (CREG) is in charge of the regulation of the power sector. CREG regulates activities of the electricity and gas sector through mandatory resolutions. Such resolutions have implemented the Electricity Law and have created a free and competitive electricity market;

(2) The Superintendency of Public Utilities controls, inspects, and supervises the entities which render domiciliary public services;

(3) The Mining and Energy Planning Unit (UPME) plans the expansion of the power sector and prepares and updates the National Expansion Plan;

(4) The National Dispatch Center (NCD) is in charge of the integrated operation of the generation, interconnection, and transmission resources of the National Interconnected System;[3]

(5) The National Operations Council (NOC) is in charge of technical matters related to the safe, reliable, and economic operation of the system, and of the enforcement of the Operation Code; and

(6) The Permanent Consultative Body (PCB) is a permanent consultative body of the Ministry of Mines and Energy, formed by representatives of the companies involved in the power sector.[4]

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[3] Additionally, the NDC coordinates the maintenance programs for the generation facilities, and for the interconnection and transmission lines.

[4] The PCB's opinion should be considered in the adoption of programs for the power sector.

### 3. Activities of the Power Sector

The activities of the power sector are considered as public services subject to the government's planning, supervision, and control. Such activities are generation, interconnection, transmission, distribution, and trading.

The activities of the sector may be undertaken by any economic agent, either private, public, or mixed. The agents performing any of the activities of the sector must be registered before CREG.

Colombia's electricity sector is interconnected with lines covering the Atlantic and Pacific Coasts, Andean Region, and part of the Oriental Plains. Companies connected to the NIS and created after Law 143 may not undertake more than one activity of the sector. However, trading may be combined with generation or distribution.

Public utility companies, existing prior to the enactment of the Public Utilities Law, may continue to perform their activities in a combined fashion. CREG has the authority to require agents to divide their activities in different companies if integration restricts competition.

The regulated market is defined as a market where the regulated users and their suppliers of electricity interact. Regulated users are those with a maximum demand less than 0.5 MWs. The tariffs of the regulated market are enacted through a CREG formula. The competitive, or free market, is a market where the non-regulated (or large users) and their suppliers of electricity interact. Non-regulated users are free to purchase energy from any supplier and are not subject to any procedures for such purchases.[5] The parties freely agree the tariffs of the regulated market.

Colombia also has a wholesale electricity market that has been operating since July 20, 1995. The agents participating in the wholesale market are all generators connected to the NIS with a capacity of more than 20 MW, and all traders (basically distribution companies and few pure trading companies). Energy is sold at the wholesale market either through long-term sale agreements or on a spot basis at the energy pool. The price of energy sold via contracts is freely agreed by the parties, whereas the price at the energy pool is determined by the offer and the demand, on an hourly basis, and corresponds to the price offered by the most expensive generation unit dispatched for that hour.

### 4. Permits, Licenses, and Taxes

Any agent rendering any of the activities of the sector has the obligation to obtain all the corresponding permits and licenses, particularly the environmental license, permits for the use of water, and any other authorization required by the applicable laws.

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[5] Regulatory Commission for Energy and Gas Affairs, Resolution 20/96, article 2.

In addition, any agent must be recorded before CREG, the UPME, SIC (*Sistema de Intercambios Comerciales*), and the Superintendency of Public Utilities.

The taxes applicable to the power sector are the following:

(1) Corporate income tax of 35 per cent;

(2) Income tax for foreign investors of seven per cent (35 per cent on profits not taxed at company level);

(3) Energy public services are excluded of value added tax (VAT);

(4) Industry and commerce at 0.2 per cent — one per cent of gross income (generators must pay according to installed capacity); and

(5) Environmental contribution applicable to generators: up to six per cent of electricity sales.

## B. PROJECT FINANCE IN THE COLOMBIAN POWER SECTOR

### 1. Overview

With one of the most stable economies in Latin America, Colombia has proven to be attractive to project financiers.

Since the opening of infrastructure development to the private sector in 1991, Colombia has attracted the attention of power, oil and gas, and telecommunications sponsors and developers.

#### a. *Privatization of State-Owned Electricity Companies*

The state has significantly reduced its ownership participation in the electricity sector, seeking strategic investors with the ability to provide technology, know-how, and capital. From a legal viewpoint, it must be highlighted that, due to a Constitutional provision, whenever the state is to sell its participation in any company, shares must first be offered to the so-called "solidarity sector". Unions, workers, employee funds, mutual investment funds, pension and severance funds, and cooperative entities essentially form the solidarity sector.

Privatization procedures were regulated by Law 226 of 1995 which, in compliance with article 60 of the Constitution, provides that a first round be carried out where the full per cent of state shares must be offered to the "solidarity sector" for a fix price per share. On compliance with the former, the remainder can be freely offered to private investors. The "solidarity sector" must also be granted special terms and conditions so as to facilitate the acquisition of shares, including loans for a term not lower than five years, with very favorable interest rates, which can be guaranteed with the same shares to be acquired.

The particular privatization programs must be prepared by the relevant Minister, together with the Ministry of Finance, and later submitted to the Council of Ministers for approval. A process to qualify the investors, so as to assure the technical and financial capacities of potential buyers, sometimes precedes the rounds where the shares are offered to private investors. At the end of the actual offering round, shares are awarded to the investor who offered the highest price.

*b. Private Capitalization of State-Owned Companies*

Capitalization of state companies is another mechanism that has been used to bring private investors to the sector. Essentially, the state contributes strategic assets, and the private investors an amount of capital usually equal to the valuation of the assets, minus the liabilities associated with them. Unlike a plain privatization, here the state does not sell its shares but increases the capital of the company, such increase being subscribed by the private investor, without an offering to the solidarity sector.

As a result of a capitalization, the state and the private investor end up as partners in the company, the latter having control of the company. Hence, one of the main issues is the regulation governing such relationships, with shareholder agreements becoming essential. Usually, the private capitalization process is done pursuant to a competitive process where the interested private investors compete, each offering an amount to be contributed to the company, and the shareholders' agreement is part of the bidding documents. Thus, there is no room for a direct negotiation with the state, aside from parliamentary questions and answers, and comments sessions. Shareholder agreements usually provide for special majorities, rules for dividend distribution, or board composition.

Finally, another issue which needs to be addressed in a capitalization structure, is the application of the laws and regulations on the surveillance of public funds, given the government participation. These rules can imply reporting obligations to the relevant state comptroller as well as its involvement through inspections and visits.

*c. Government Goals for 2000*

The government has established ambitious goals for the development of infrastructure in its four-year period from 1998 to 2002, principally covering the power, petroleum, transport, gas, telecommunications, and water sectors. The government goals for the power sector are those to:

(1) Promote the access of new agents to the power sector;

(2) Increase the covering in countryside zones;

(3) Increase the installed capacity through hydro and thermal resources to a total of 14.389 MW in the year 2000;

(4) Develop hydroelectric, thermal, and geothermal projects; and

(5) Increase transmission lines for the year 2002.

## 2. Risk Evaluation

### a. Market Risk

In absence of long-term PPAs, which assured a stable flow of revenues, green-field plants being financed today must cope with the risks of the market. This means that they must compete to enter into contracts for their output, and must carefully study the performance of the Energy Pool and Dispatch Model. Regarding energy contracts, the potential purchasers are distributors and non-regulated users. Until 2000, distributors had to cover certain percentages of their demand with long-term contracts as a protection against the volatility of the pool prices.

However, from 2000 onwards, they can freely move between contracts and the spot market. In addition, since electricity supply is heavily dependent on hydropower,[6] good hydrology drives the pool prices down, deterring traders from entering into long-term contracts with fixed prices. On the other hand, the universe of non-regulated users, the other possible buyers, has expanded from 2000, with the requirements lowered to a demand of 0.1 MW or a minimum monthly consumption of 55 MW. Since non-regulated users are not allowed to directly participate in the wholesale market, traders, generators, and distributors are fiercely competing to capture them.

Even though non-regulated users are not used to negotiating for energy with a provider other than from a regular distributor, active marketing by trading companies is changing this. As to the energy pool, given price volatility and dispatch uncertainty, CREG introduced a very important source of revenues for generators to foster expansion. This is known as the "capacity charge" and is intended to remunerate plants for their availability, even if not dispatched, based on a capacity figure determined through formulas set by CREG and simulations of the energy they could provide to NIS under severe hydrologic conditions.

### b. Payment Risk

Sellers at the energy pool must also deal with payment risk. At the pool scenario, sellers cannot choose whom their buyers are, being exposed to the uncertainty of their credit. Moreover, payment risk for pool transactions cannot be handled by generators on an individual basis, since sales are proportionally assigned by the Administrator of the Commercial Exchange System (ASIC)[7] to all

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[6] Hydro generation amounts to almost 70 per cent of the total generation.

[7] Currently, the Administrator of the Commercial Exchange is a unit of ISA, but this role will be transferred to a new company given the forthcoming privatization of ISA.

generators of the market based on the energy hourly delivered to NIS. Prior to the private capitalization of the distribution companies of the coast, payment situation was critic since these companies were in harsh financial conditions having ceased payments to the pool, with debts amounting to incredibly high figures.

To counter this problem, regulations require market participants to deliver to the ASIC payment guaranties and promissory notes prior to commencing their activities. In addition, supply restriction programs have been authorized affecting distribution companies failing to meet their payment obligations, including pool purchases, transmission charges, and any other amount due to the ASIC and to the Liquidator and Administrator of the Transmission Accounts (LAC).[8] Payment performance is also expected to improve as private investment joins the industry.

*c. Fuel Risk*

This is an issue for gas-fired plants, since the gas market is not yet developed, and Ecopetrol, the state oil company, has control of almost all gas production (royalty gas plus the state's share under all E&P contracts). There is a maximum price set by CREG, which varies depending on the regional location of the field and the date of execution of the respective E&P contract.

However, CREG is currently modifying the price structure, and new regulations are expected soon.[9] Gas-fired plants in operation today have faced serious difficulties due to the strict take-or-pay contracts offered by Ecopetrol. Such situation has worsened due to hydrological conditions, since plants are not being dispatched but are paying the take or pay, with no secondary market for gas to mitigate the risk.

*d. Force Majeure Risk*

The scope of *force majeure* risk is subject to determination of the judge, on a case-by-case basis, based on the evidence submitted by the interested party.

*e. Political and Security Risk*

Political guerrilla activities threaten the peace process and stability of Colombia.

### 3. Contractual Package Commonly used in Power Finance in Colombia

The contractual package will include design, procurement, construction, engineering and maintenance, take or pay, fuel supply, materials supply, and other agreements.

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8 Regulatory Commission for Energy and Gas Affairs, Resolution 116 of 1998.

9 Regulatory Commission for Energy and Gas Affairs, Resolution 55 of 1999.

The structure of the project may call for lease agreements and trust agreements to be executed, in addition to the security arrangements which usually require pledge of shares, pledge or mortgages of the project assets, and assignments of the project contract. In certain cases, the lenders may want to take a so-called "pledge of commercial establishment" which implies a pledge over all assets of the business as an ongoing concern.

The purpose of this agreement is to hold some of the assets of the project and to channel the revenue stream through it. The trust effectively isolates the assets from the project company's creditors other than the lenders.

#### 4. Local Investment Vehicles

Energy-related activities must be performed by *Empresas de Servicios Públicos* (ESP). ESPs must be incorporated as stock companies, which could be corporations or limited partnerships, by shares.

Foreign companies which will perform permanent activities in Colombia must incorporate a branch. ESP's may be owned by foreign companies incorporated with the purpose of issuing securities abroad, or for channeling the funds for financing the project.

#### 5. Foreign Investment Regulations

The Colombian Constitution has the following principles for foreign investment:

(1) Equal treatment — Foreign investment is subject to the same treatment as domestic investment. No discriminatory conditions may be imposed on foreign investors.

(2) Universality — Foreign investment is allowed in all economic activities (only restricted for defense and national security and toxic waste disposal).

In most cases, companies rendering public services will receive foreign investment as:

(1) Money contributions made by importation of foreign currency (to be converted into Colombian currency) for payment of shares or quotas of a Colombian company;

(2) Contribution in kind either in the form of tangible or intangible goods, or

(3) Initial or supplementary investments in the assigned capital of branches established in Colombia by foreign companies.

In addition, Colombian companies may receive imports of foreign currency to purchase real estate located in Colombia and capitalization of resources in domestic currency with foreign remittance rights. Foreign debts, reimbursable imports, profits with remittance rights, and royalties on technology contracts, trade marks, or patent licenses may be capitalized in a Colombian company.

Foreign investment must be recorded with the Colombian Central Bank (*Banco de la República*). The recording of the foreign investment grants "exchange rights" to the investor,and lack of such recording constitutes an administrative offense that may be penalized with fines of up to 200 per cent of the invested amount.

The "exchange rights" are:

(1) The right to remit abroad the profits from the investment;

(2) The right to re-invest the profits, or to keep as surplus any undistributed profits with remittance rights;

(3) The right to capitalize the amounts with remittance rights; and

(4) The right to remit abroad the proceeds from the sale of the investment, or from liquidation of the company, or from reduction of capital.

The following are international agreements to protect foreign investment in Colombia:

(1) The Overseas Private Investment Corporation (OPIC) — The OPIC was formed to promote the United States investment in developing countries. Since 1985 Colombia has been covered by the OPIC. OPIC finances and insures investment projects against risks such as foreign currency inconvertibility, discriminatory expropriation, and political violence.

(2) The Multilateral Investment Guarantee Agency (MIGA) — The MIGA offers guarantees against non-commercial risks, such as war and civil unrest.

(3) The International Center for Settlement Disputes (ICSID) — The ICSID provides a mechanism for international conciliation and arbitration. The agreement was signed and ratified by Colombia.

## C. PROJECT FINANCE IN COLOMBIA'S POWER SECTOR

A brief description of some of the project finance in the Colombian power sector follows:

(1) EPSA — EDC and Houston Industries acquired 100 per cent of EPSA shares. EPSA is involved in distribution, and transmission, and has

more than 800 MW of generation capacity, equivalent to 6.9 per cent of the total generation capacity of the Colombian market.

(2) Chivor — In 1996, the 1,000 MW hydro plant of Chivor was acquired by Chilgener. Chivor has 8.6 per cent of the total generation capacity of the Colombian market.

(3) EEB (Emgesa and Codensa) — Endesa acquired 48 per cent of Emgesa, a generator with 2.542 MW equivalent to 21.92 per cent of the national capacity. Endesa acquired 48 per cent of Codensa, the company in charge of distribution in Bogotá, a city with more than six million people.

(4) TermoEmcali — The benchmark US $250 millon project financing for 234 MW (2.02 per cent of the market) was a greenfield natural gas-fired power project.

(5) KMR TermoCandelaria — The US $175 millon project, operating as a merchant plant, will sell its electricity into the energy pool. TermoCandelaria, which is 100 per cent owned by KMR, is being financed under a unique two-tranche bank facility structure created for this project by the company. It consists of a US $90 million senior loan and US $85 million subordinated.

TermoCandelaria is not only the pioneer project financing with an insurance company guaranteeing a large portion of debt, but it also represents the first true flow of commercial underwritten project finance debt for an infrastructure project in Latin America since the economic crisis spread throughout the region. Termocandelaria's capacity is 300 MW, equal to 2.59 per cent of Colombia's power market.

## D. INVESTMENT OPPORTUNITIES IN THE COLOMBIAN POWER SECTOR

### 1. Incorporation of Private Capital

During 2000, the government will close several tenders to incorporate private capital in the following companies, as well as to expand the transmission system, including Interconexión Eléctrica S.A. (ISA), Isagen S.A. E.S.P (ISAGEN), and Electrificadoras Group.

ISA is the only transmission company in Colombia. The transmission activity is a natural monopoly controlled by CREG. During 2000, the Colombian government

will offer its ownership in the company. Flemings-Corfinsura consortium is managing the privatization process. Its balance sheet is:

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|---|---|
| Assets: | US $1.4 million |
| Liabilities: | US $683,989 |
| Equity: | US $794,938 |
| Net Profit: | US $82.2 million[10] |

ISAGEN controls 14.66 per cent of the total installed generation capacity in Colombia (1700 MW).

The government is in a process to privatize its ownership in the company equivalent to 76.9 per cent of the outstanding shares of ISAGEN. To date, the offering is managed by Inverlink Investment. Its balance sheet is:

| | |
|---|---|
| Assets: | US $1.4 million |
| Liabilities: | US $496,683 |
| Equity: | US $993,545 |
| Net Profit: | US $5.8 million[11] |

The Electrificadoras Group has 14 companies with a total generation capacity of 559 MW representing 4.8 per cent of the national generation capacity, transmission lines, distribution, and trading operation. Such companies are located in the central region of Colombia. Rothschild Investment is managing the legal, financial, and technical structuring. Its balance sheet is:

Assets: US $1.2 million[12]

## 2. Market Structure — Investment in the Generating Sector

| | Before 2000 Privatization | After Privatization |
|---|---|---|
| Private Investment | 46 per cent | 78.1 per cent |
| Public Investment | 54 per cent | 21.9 per cent |

10 Source: National Planning Department.

11 Source: National Planning Department.

12 Source: National Planning Department.

### 3. Market Structure — Investment in the Distribution Sector

| | Before 2000 Privatization | After Privatization |
|---|---|---|
| Private Investment | 44 per cent | 82 per cent |
| Public Investment | 56 per cent | 18 per cent |

### 4. Expansion of the National Transmission System

To achieve the expansion of the National Transmission System, the UPME summons the interested parties to submit proposals for the design, operation, and maintenance of the transmission lines. The selected contractor will operate the line and will be remunerated according to terms of the bid.

# CHAPTER 6
# PROJECT FINANCE IN A TROUBLED CHINESE MARKET

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## A. INTRODUCTION

Due to its sheer size, population, and infrastructure opportunities, many project participants view China as one of the most important emerging markets, for infrastructure development, in the world today. This is despite, seemingly, unfavorable market conditions and sentiment driven by the general financial crisis in Asia and the recent spate of loss of confidence by foreign financiers lending into China. The financial crisis was mainly caused by the collapse of Guangdong International Trust and Investment Corporation (which was declared bankrupt by the Chinese court on January 16, 1999), and the uncertain nature of a number of high-profile debt restructurings concerning well-known Chinese enterprises.

These developments have considerably reduced financiers' appetite for new project finance, thereby hampering project sponsors' chances of a successful financing in China. For financiers exposed to existing projects in difficulty, recent times have seen the imposition of tighter monitoring by financiers as well as regulatory authorities within China. Both foreign sponsors participating in and financiers lending into such projects have experienced a difficult environment in which all concerned had been taught valuable lessons in risk management and control.

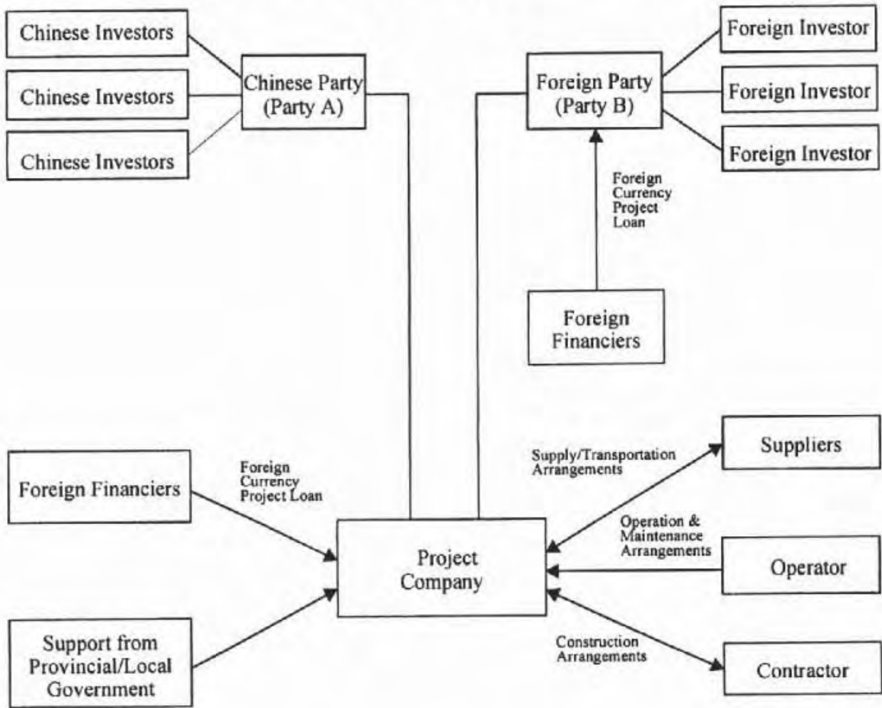
This chapter will examine a selection of the key issues facing project finance in China today. The issues may not be vastly different in principle from those in other developing countries in Asia, although Chinese issues have their own special twists and turns. The general structure for financing projects (see Diagram A1) have not changed drastically in the recent past although both the law and other regulatory considerations have.

First examined, will be China's developing legal system and its laws, followed by an overview of the regulatory environment regarding project finance, and a look at China's tightening foreign exchange regime. The question of the Chinese participants' conflict of interest issues and credit risk associated with Chinese participants in projects are then discussed, as well as the topic of renminbi (People's

Republic of China's currency) financings essential to complement foreign currency financing for projects. This chapter concludes by examining Build Operate Transfer (BOT) projects and other alternative concepts that have been used in project financings in China.

Diagram A1

## Typical Chinese Project Type Finance Structure

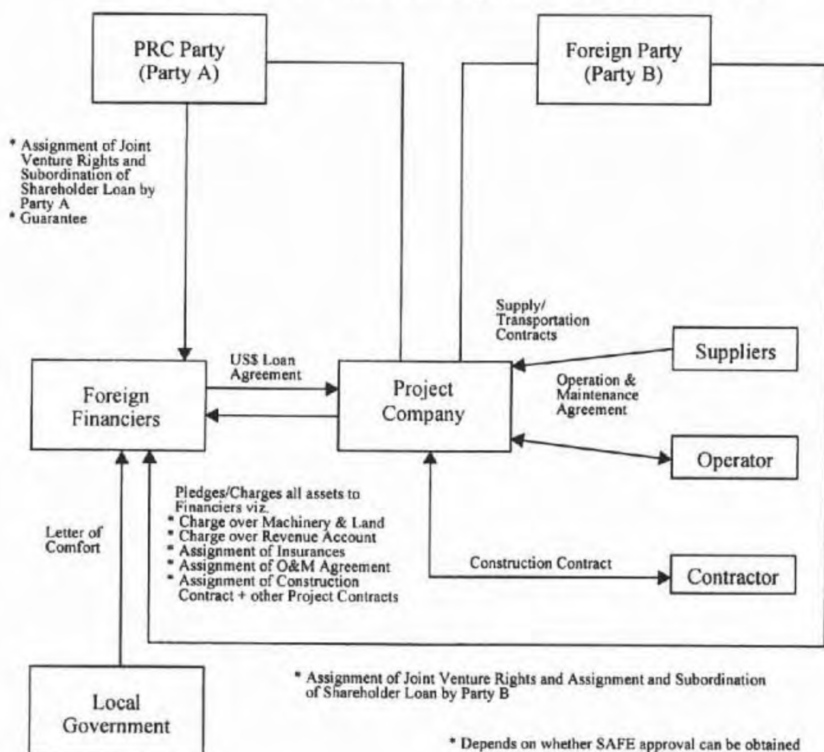



Depending on the specifics of the project and the requirements of the sponsors, the financing is sourced through either the foreign party (Party B) — normally an offshore special purpose vehicle whose ultimate shareholders are the foreign sponsors — or the project company, which can be a Chinese cooperative or equity joint venture established in accordance with the respective Sino-foreign cooperative or equity joint venture laws. Sometimes the project company will be a wholly foreign owned Chinese enterprise (as in the BOT projects referred to elsewhere). If the financing is sourced through Party B, the structure should enable Party B to inject the proceeds of the financing as a shareholder loan to the project company although this option is restricted by existing rules regarding minimum equity investments.

For non-recourse or limited recourse project financing structures, the taking of security is essential. Diagram A2 shows a basic security package involving security over the assets including receivables of the project company. Most project financings in China would involve some sort of recourse by way of support from sponsors, their associated parties, or a third-party financial institution to make the transaction bankeable, to the extent the relevant approvals for such support are forthcoming.

Diagram A2

**Security Structure for Typical Project Finance**




## B. DEVELOPING LEGAL FRAMEWORK

### 1. Background

As any project financier would point out, it is a fundamental principle of project financing that a stable, consistent, and predictable system of law govern the relationship between project participants (including financiers). Without such system of law, it will be difficult for project participants to assess the extent of their risk as well as remedies should problems occur with the project.

The Chinese government fully recognizes this principle with the result that the Chinese legal system has seen increasing sophistication over time. The last decade has seen many laws being implemented and an increased focus by the Chinese government to ensure the development of a strong and stable legilative framework to attract foreign investors, and with it financiers willing to lend to Chinese projects. Diagram B lists some of the key legislation relevant to project finance in China, most of which were promulgated in the last five years.

Diagram B

**Key Project Finance-Related Laws**

Lending and security-related:

- *The General Lending Provisions* (1996)
- *The Administration of Project Financing Conducted Outside China Tentative Procedures* (1997)
- *The Administration of Borrowing of International Commercial Loans by Domestic Organizations Procedures (1998)*
- *Security Law 1995*

Project-related:

- *Several Issues Concerning the Examination, Approval and Administration of Experimental Foreign-invested Concession Projects Circular (1995)*
- *Circular to the Ministry of Foreign Trade and Economic Cooperation on Several Issues concerning the Absorption of Foreign Investment by the BOT Method (1995)*

Industry-related:

- *Electric Power Law 1995*
- *Water Law 1988 and the Industrial Policy on Water Resources 1997*
- *Highways Law 1997*

Foreign exchange-related:

- *Regulation of the PRC for the Control of Foreign Exchange* (1996, revised 1997)
- *Administration of the Settlement, Sale and Payment of Foreign Exchange Provisions* (1996)
- *Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China Procedures (1996)*
- *Administration of Foreign Exchange Accounts Inside China Provisions* (1997)

General:

- The PRC Law on Sino-foreign Joint Equity Enterprises (Revised) (1990)
- Sino-foreign Cooperation Joint Venture Law 1988 and the Implementing Rules of the Law of the PRC Sino-foreign Cooperative Joint Venture Law 1995
- Wholly Foreign-owned Enterprises Law 1986 and the Implementing Rules of the Law of the PRC Wholly Foreign-owned Enterprises Law 1990
- Contract Law 1999
- Securities Law 1999
- Land Administration Law 1998

Nevertheless, the Chinese legal system and its body of laws still remain, relatively speaking, in an infancy stage compared to other established Western legal systems. The economic downturn in Asia, together with bad or problem debt exposure in China, has proved very trying for foreign investors and financiers lending to projects within China. In fact, recent experience of project participants and financiers in enforcing remedies in China has actually highlighted the drawbacks of the developing Chinese legal system.

The current, rather pessimistic, attitude of project financiers, damaged by the unpredictability and other impracticalities of the Chinese legal system, is a far cry from the good old days of Chinese project finance when most financiers felt very "gung-ho" despite the legal risks.

While specific problem areas faced by project participants may vary from project to project, industry to industry, and from one location to another, there are a number of recurring problem areas that project participants appear to be facing, namely: inexperienced judiciary, expense of litigation, dealing with conflict of laws, realizing security, and treatment of creditors.

## 2. Inexperienced Judiciary

It is all very well for the legislature to be promulgating new laws. However, with the sheer size of China and the spread of the courts, judges require time to be trained to understand the new laws, let alone enforce them. The standards maintained by the judiciary can vary from location to location, and it will take time for the judiciary to attain the internationally accepted standards expected by project participants.

One problem often cited by project participants is the apparent inability of some judges to grasp the key issues in complex financial and contractual claims involving project participants which require resolution in the Chinese courts. This may happen even for some relatively straightforward debt claims. Sometimes, this apparent problem is mitigated by having the matter resolved via arbitration by an independent arbitrator or a committee of arbitrators since arbitrators are normally well-experienced in the types of contentious issues on which they have been appointed to arbitrate.

Nonetheless, arbitration cannot solve all contentious issues, and the courts remain an important forum for resolution of disputes or remedy enforcement. While project sponsors, joint venture parties, operators, suppliers, and off-takers may wish to resort to arbitration as an initial dispute resolution measure, project financiers will normally not wish to do so since their grievances would usually be related to non-payment of loans, in which event it would be difficult to see what there is to arbitrate on.

### 3. Expense of Litigation

Another discouraging aspect of the Chinese legal system is that the cost involved in bringing a legal action to enforce legal rights and remedies in a project in Chinese courts can be prohibitive. The expense involves two elements, i.e., court costs and Chinese lawyers' fees. To bring litigation proceedings in a Chinese court, there is a case acceptance fee payable to the court in advance. Such an acceptance fee is calculated as a percentage of the amount of the claim concerned, although this fee may be borne by the party ultimately held by the court to bear the costs of litigation. In China, legal fees charged by lawyers are usually calculated by reference to the amount of the claim. A plaintiff wishing to bring litigation could be charged as much as two per cent of the amount of its claim when taking into account aggregating court and lawyers' fees.

It is also a requirement under Chinese law that non-Chinese documents need to be translated into Chinese and certified by court approved officers, which can also involve considerable expense in project finance transactions where documentation is lengthy and often only written in English. Because of these cost factors and the relative uncertainty of remedies, project participants often think twice before commencing litigation proceedings in China.

### 4. Dealing with Conflict of Laws

The Chinese courts' treatment of the conflict of laws is another concern for project participants. Due to the seemingly inadequate or unsatisfactory legal remedies a project participant may obtain from a Chinese court under Chinese laws, foreign sponsors and financiers would usually require project documentation to be governed by a system of law with which they are more familiar and which affords them adequate protection.

A common governing law provision in a project contract not required under Chinese law principles to be governed by Chinese law would normally refer to English or New York law as the express choice of governing law agreed by the parties to that contract. It is then common to have, as a condition to closing any project financing, a Chinese law firm to confirm in its legal opinion that the Chinese courts would recognize this express choice of law and give effect to it.

However, recent experience with the court system has cast doubt on the extent to which the Chinese courts recognize and acknowledge this express choice of law. The problem is not always that the courts may not recognize how English or New York law applies to resolve a conflict, but rather that the courts will nonetheless apply Chinese principles and standards of law to the dispute. The result will often be that, had all Chinese formalities been satisfied by the standards of the court, Chinese remedies would apply.

The Chinese court may have conveniently bypassed the protection that the express choice of governing law had meant to provide. The lesson to be learnt here

is that, for project participants, while they may have an inadequate understanding of how Chinese law works or is applied and thus opt to use a foreign governing law, all the requirements (substantive as opposed to procedural law) under Chinese law still need to be satisfied before Chinese courts will enforce remedies within China.

One aspect of the problems experienced by aggrieved project participants is the uncertain attitude of the Chinese court towards enforcement of foreign judgments in China. Despite a reciprocal enforcement of judgments treaty being signed between China and a jurisdiction in which the foreign party successfully obtains a judgment against a Chinese party, the procedural and practical aspects of enforcing such foreign judgment in China can be daunting for the foreign party wishing to enforce that judgment.

## 5. Realizing Security

Project financiers have learned from the Guangdong International Trust and Investment Corporation (GITIC) insolvency saga, as well as from bad debt episodes affecting other Chinese borrowers, that there is now a real need for financiers to consider the possibility of having to actually realize their security on project assets located in China. This might be a financier's ultimate remedy, which it would only use as a last resort. However, the economic downturn in Asia, coupled with the levels of bad and problem debt carried by certain banks in the finance market in China and banks' internal policy to retreat from loss-making areas, has meant that the use of this last resort remedy remains a real and imminent step.

The process of realizing security in China is not as easy as it would appear. Numerous problems have been encountered by financiers attempting to realize their security inside China. The timeframe taken to achieve success or to force an acceptable settlement is usually much longer than what a financier initially expects.

One problem faced by financiers is trying to persuade the Chinese courts that their security documents are effective under Chinese legal principles. For example, it is not uncommon for project security documents to stretch to pages and pages containing many boilerplate provisions frequently used in Common Law jurisdictions that could have been extremely useful and protective for financiers if used in those jurisdictions. However, when transplanting these foreign concepts to security being taken inside China, care should be taken to ensure that these concepts can actually be understood by Chinese courts, let alone being enforced by such courts.

For one thing, it is essential to use Chinese security concepts where possible. It is not uncommon to find close scrutiny of foreign security concepts by the Chinese courts, which may delay the enforcement process, or worse, hamper it altogether. For instance, where the security document uses principles or remedies foreign to Chinese law (a receivership provision or a trust concept), care needs to be taken to ensure the Chinese court does not misinterpret these concepts. Additionally, and just as importantly, financiers who do not monitor the latest procedural or other

formalities that apply to any security taken (especially those taking retroactive effect) may be in line for a shock when it comes to enforcing their security.

### 6. Treatment of Creditors

One of the lessons learnt from the recent GITIC insolvency was the treatment accorded to different classes of creditors, especially in the absence of clear law. In addition, treatment of various classes of creditors may have political or policy overtones. While the bankruptcy of GITIC (a Chinese state-owned enterprise) could not be said to be representative of the way creditors would be treated, this would not prevent project participants, especially financiers, from drawing parallels to the situation where a project company (a Chinese private enterprise) undergoes bankruptcy under Chinese legal principles.

Creditors of GITIC found the process of bankruptcy and assessment of claims rather disconcerting, in terms of what types of claims are admissible and what was not. In the wake of GITIC's bankruptcy, creditors became increasing concerned over the treatment of the Chinese government of other International Trust and Investment Corporations (ITIC) that were also financially unsound.

There have been as yet unconfirmed reports that certain types of creditors were being prevented from having their court actions against other troubled ITIC progressed, a development if which, accurate, would no doubt be of grave concern to any project participant exposed to ITIC and other state-owned or government-backed enterprises, such as off-takers.

It is also often felt among foreign creditors in Chinese problem debt cases that somehow Chinese creditors would have priority in respect of their claims over those of foreign creditors. This feeling is not unsubstantiated because foreign creditors have on occasions experienced substantial resistance in the Chinese courts to their rights over security or claims they felt they were entitled to ahead of other Chinese creditors. This is even so where there are or may be extenuating circumstances in each particular case.

## C. THE CHINESE REGULATORY ENVIRONMENT FOR PROJECT FINANCE

Project finance in China is fast becoming increasingly regulated and put under scrutiny by the Chinese government. While many other laws will have a bearing on various aspects of project finance, there are in particular two laws addressing the regulatory framework surrounding project finance.

These are the Administration of Project Financing Conducted Outside China Tentative Procedures (Project Finance Procedures) issued by the State Development and Planning Committee (SDPC) (formerly the State Planning Commission), and the State Administration of Foreign Exchange (SAFE), which took effect on April 16, 1997. Some of the procedures were repeated in the Administration of Borrowing of International Commercial Loans by Domestic Organisations Procedures

(International Commercial Loan Procedures) issued by the People's Bank of China and SAFE, which took effect on January 1, 1998.

Under article 1 of the Project Finance Procedures, "project finance" is defined as a method of financing pursuant to which foreign exchange funds are raised outside China in the name of a construction project in China and where the debt payment liability to the foreign entity is limited to the expected revenue from, and the assets of, the project itself. Under article 1, project finance should have the following characteristics:

(1) The creditors have no recourse against any assets or revenue other than those of the construction project;

(2) Domestic Chinese institutions do not mortgage, pledge, or use for the repayment of debt any assets, rights, or revenues other than those of the construction project; and

(3) Domestic Chinese institutions do not provide any financing guarantees in any form.

The Project Finance Procedures further provide that non-financial institutions may provide performance guarantees only if the relevant department in charge of such non-financial institutions so approves.

The Project Finance Procedures basically describe project finance in its pure form, i.e., non-recourse project finance. If categorized as a "project finance" under the Project Finance Procedures, the following procedures are undertaken:

(1) A preliminary examination of relevant papers is conducted by the government department in charge of the relevant industry;

(2) The project proposal and feasibility study report must be issued by the local government planning departments;

(3) The project proposal and the feasibility study report must be submitted to the SDPC for examination and approval; and

(4) "Major" projects (commonly understood to mean those projects over US $100 million) must be approved by the State Council following an examination by the SDPC.

A feasibility study report should contain certain information and documents, including:

(1) Qualifications of and risk-sharing principles between key investors and other parties;

(2) Methodologies for balancing foreign exchange and the amount of foreign exchange required during the term of operation;

(3) Principles for determining the price of the products or services and formulae for price adjustments;

(4) Project financing plan;

(5) Document issued by the foreign credit institution in which it states its intent to commit itself to the loan; and

(6) Draft of the principal contract for the project, which may not be subsequently altered and which is subject to approval by the relevant government authority.

After approval of the project proposal and the feasibility study report is obtained from the SDPC, the proposed financing will be included in the national plan for borrowing of international commercial loans. There is also a requirement that the terms of the financing must be competitive and that the financing be separately examined and approved by SAFE.

To date and in light of the difficult market conditions in China lending, it remains generally unrealistic for project financiers to structure project finance on the non-recourse basis described above. Rather, limited recourse financing would appear more realistic with some form of governmental support anticipated, and financing structures would be made to avoid having to comply specifically with the Project Finance Procedures.

Despite this, there remains, generally speaking, a whole host of specific approvals required at various stages of a project. Diagram C highlights generically some of the key approvals required in setting up the project entity. Diagram D shows generically the authorities with whom the project company needs to liaise regarding various aspects of a project. Obviously, the type of approval required will vary from project to project and industry to industry, and the lists set out in these Diagrams are not meant to be exhaustive. It is not uncommon to find that a great deal of patience is required in the approval process.

Indeed, it is critical for foreign investors and sponsors to ascertain not just which approvals are required from governmental authorities, but also the appropriate level of authority (for instance, at local, provincial, or central governmental level) at which their project should be approved.

Diagram C

## Typical Governmental Approvals Required for Projects

Key governmental approvals for setting up project company:

| **Documents** | **Approval Authority** |
|---|---|
| • Feasibility study report | • MOFTEC or COFTEC and planning commission to approve |
| • Articles of association and (if a joint venture) joint venture contract | • MOFTEC or CDFTEC to approve |
| • Approval certificate of joint venture | • MOFTEC or COFTEC to issue |
| • Business licence | • State Administration of Industry and Commerce (SAIC) to issue |
| • Foreign investment enterprise (FIE) foreign exchange registration certificate, and Notification for account opening | • SAFE to issue for purpose of opening foreign exchange accounts |

Key governmental approvals for project financing:

| **Documents** | **Approval Authority** |
|---|---|
| • Project proposal, feasibility study report | • Local government planning department to issue |
| • Project proposal, feasibility study report | • Government department in charge of relevant industry to do prliminary examination |
| • Project Proposal, feasibility study report<br>• For projects<br>• For "major projects" over US$100 million | • State Development and Planning Commission (SDPC) to examine and approve<br>• MOFTEC in Beijing to approve<br>• State Council to approve |
| • Terms and conditions of financing (submit together with application documents, feasibility study report approved by SDPC, document evidencing inclusion of project finance in the State, andy project finance document in the nature of a guarantee) | • SAFE to approve |
| • Chinese non-financial institution performance guarantee | • Relevant department in charge of such non-financial institution to approve |

Diagram D

**Key Governmental Institutions Involved in Project Finance**

| Government Institutions | Involvement |
| --- | --- |
| • Local government planning department | • project proposal and feasibility study report |
| • Government department in charge of relevant industry | • main project documents and of setting up of project company |
| • State Development and Planning Commission (SDPC)<br>• | • main project documents and approval of setting up of project companies |
| • Local commissions for foreign trade and economic cooperation (COFTECs) and Ministry of Foreign Trade and Economic Cooperation (MOFTEC) | • setting up of project company and issue of import and export licences |
| • State Council | • "major" projects with investment exceeding US $100 million |
| • State Administration of Industry and Commerce (SAIC) | • business licence of project company |
| • State Administration of Foreign Exchange (SAFE) | • financing terms and foreign exchange controls |
| • Local environmental protection bureau | • Environmental review at preliminary feasibility stage |
| • Local labour bureau | • employment permits for expatriate personnel |
| • Customs bureau | • exemptions and reductions where applicable and obtain clearance |
| • Local tax bureau | • tax concessions and holidays applicable to project in specific industry |
| • Local water resources bureau and construction commission | • rights on waterways and landing rights |
| • Land administration bureau | • land use rights |

## D. CHINESE PROJECT PARTICIPANTS AND CONFLICTS OF INTEREST

The majority of projects set up in China are joint ventures between a Chinese party (customarily referred to as Party A) and the foreign party (referred to as Party B). It is commonly felt by foreign sponsors that close cooperation with a Chinese partner is essential to the success of a project. Even so, there have been cases where wholly foreign-owned enterprises were set up as Chinese project companies. For these wholly foreign-owned enterprises, as well as Sino-foreign joint venture

enterprises, close cooperation with Chinese entities remains an important and essential part of each and every milestone in a project.

The selection of a Chinese partner for a Sino-foreign project company in China should only be made after extensive (and preferably independent) due diligence, as experience shows that the selection of an ineffective or wrong partner has dire consequences for the project, including its finance capabilities and profitability. The influence and relationships that the Chinese partner can be brought to bear on relevant parties (commonly known as *guanxi*) is an important factor, and so is the credibility and creditworthiness of the Chinese partner.

Often, the Chinese partner may itself be a consortium of Chinese enterprises and, like any consortium, the constituent participants may have differences that can adversely affect the well-being of the project. It is also essential to investigate the resources of the Chinese partner and the likely mobility of its key influential officers, as this can have a drastic effect on the project should its key officers get transferred or shuffled elsewhere. As the Chinese partner plays a major role in lobbying for, and obtaining most if not all of Chinese approvals and licenses and would usually deal with the regulatory authorities and renminbi financiers directly, its "Mr. Fix-it" role cannot be underestimated.

The issue of conflicts of interest surrounding the Chinese partner's roles in a project remains a real concern for financiers. For instance, as is seen in numerous projects, related entities or even one entity would be the sponsor, off-taker, equipment or fuel supplier, and part of the contractor-consortium. This fact is acknowledged in the Administration of Project Financing Conducted Outside China Tentative Procedures (April 1997) which serves, amongst other things, to prevent conflicts of interest arising in projects and to promote transparency.

In many ways, conflicts of interest may be inevitable since local or provincial governments and their subsidiaries or associated enterprises tend to become involved in numerous aspects of a project. The risk of collusion between associated parties cannot be avoided altogether, but care needs to be given to mitigate such risks by a variety of mechanisms, such as not permitting conflicting parties to vote, or establishing weighted or special voting procedures in respect of contracts or decisions involving conflicted parties.

## E. ASSESSING THE CREDIT RISK OF CHINESE PROJECT PARTICIPANTS

An ongoing problem project financiers face in China is assessing Chinese participants' credit risk, a risk that is often linked to conflict of interest issues discussed in the previous section.

Chinese partners in many cases do not possess credit and accounting records considered to be acceptable by foreign financiers generally. Accounts are normally prepared under China's antiquated accounting systems rather than internationally accepted accounting standards. For those domestic corporations that have their

shares listed on Chinese or foreign stock exchanges, financial information may provide the kind of transparency financiers require. However, the same cannot be said of many Chinese project participants.

True creditworthiness is measured by reference to a variety of factors and not solely by what a Chinese party is injecting into a joint venture project and its financial state. Creditworthiness, in its broad sense, would include a Chinese party's abilities and *guanxi*, as well as its pulling and performance power. For one thing, foreign sponsors and financiers may not always appreciate the personal nature of the relationship between a Chinese partner, its key officers, and the various elements of the Chinese government, so that, when such a Chinese partner or key individual is criticized or disgraced by the Chinese government, that could have a material adverse effect on the prospects as well as the business performance of the project in question.

Another facet that requires consideration is that, the Chinese partner's familiarity with the local network and circumstances dictates that the Chinese partner will nearly always be in an influential position even if it only has a minority stake in the project.

Compounded with the problem of lack of strong local government support or guarantor support nowadays and potential conflict of interest issues, putting an accurate assessment to the creditworthiness of the Chinese partner and other Chinese participants represents a major challenge to foreign sponsors and financiers.

This is especially so in a case where the Chinese party is itself a consortium of Chinese enterprises and the reputation and track record of one consortium member differ drastically from that of another consortium member. To mitigate any failure on the Chinese party's part, resort can be made to relevant insurance policies as well as performance guarantees (assuming the relevant approvals required in this connection are obtained) to cover certain obligations of the Chinese party.

## F. FOREIGN EXCHANGE CONTROL REGIME

### 1. SAFE Controls

Foreign exchange risks remain an essential consideration for project sponsors and financiers involved in Chinese projects. These risks can be examined further in the light of currency availability, conversion and repatriation abroad, and devaluation.

In the China context, the availability of foreign currency appears not to be of much concern in light of China's large foreign exchange reserves. Instead, as further described below, foreign participants in Chinese projects (especially financiers) are more particularly concerned as to the convertibility and repatriation of foreign currency if SAFE regulations are somehow breached or left unsatisfied — a worrying topic in an era of tightening SAFE controls in this respect — and renminbi

devaluation, which have forced project sponsors and financiers to carefully scrutinize ways to hedge such possibilities.

However, before dwelling on foreign exchange risks and the problems associated with them, it is worthwhile to briefly examine the main regulations controlling foreign exchange. The Chinese government, through SAFE, controls its currency by controlling all capital account items, whereas current account items are subject to much less stringent control. Capital account items and current account items are specifically described in the relevant law.

### 2. Current Account Items

Current account items are defined, in the regulations of the People's Republic of China for the Control of Foreign Exchange (Forex Regulations), as those transactions or transfers of funds which give rise to recurring international receipts and expenditures (such as repatriation of profits by the foreign investor of a foreign investment enterprise (FIE) or interest repayment in foreign exchange loans).

Diagram E sets out a non-exhaustive list of examples of current account payments and receipts provided by SAFE in 1996 under the SAFE, Questions Relating to the Administration of the Settlement, and Sale and Payment of Foreign Exchange Provisions Explanation (SAFE Explanation).

Diagram E

| **Current Account Payments** | **Current Account Receipts** |
|---|---|
| • Foreign exchange payment for import of goods | • Foreign exchange received from the export of goods |
| • Foreign exchange payment of interest on hard currency loans | • Foreign exchange received from assignment of intangible property, such as land use rights, intellectual property rights, and goodwill |
| • Foreign exchange remittances outside China of profits and dividends of FIEs | • Foreign exchange received from leasing of real estate and other assets |
| • Foreign exchange payment for royalties arising from intellectual property rights and other intangible rights | • Foreign exchange belonging to foreign consulates in China and representative offices of foreign companies in China |
| • Foreign exchange payment for the purchase of goods from bonded zones | |
| • Outward remittances of wages and other legal earnings of foreign personnel of FIEs | |

### 3. Capital Account Items

Capital account items are defined in the Forex Regulations to include direct investment, loans, and investment in securities which give rise to international inflow and outflow of capital that increase or decrease the assets and liabilities of an entity.

Diagram F sets out a non-exhaustive list of examples of current account payments and receipts provided under the SAFE Explanation.

Diagram F

| Capital Account Payments | Capital Account Receipts |
|---|---|
| • Foreign exchange repayment of the principal of hard currency loans | • Foreign exchange received as capital contributions to FIEs |
| • Increase, assignment, or disposal by other means of the foreign exchange capital funds of FIEs | • Foreign exchange received as proceeds from hard currency loans |
| • Outward remittance of capital by the foreign parties after liquidation of FIEs | |
| • Increases in investment or reinvestment inside China using foreign parties' share of profits in FIEs | |

### 4. Foreign Currency Financings for Projects

As is seen above, repayment of foreign currency loans in project financings is a capital account payment and is therefore controlled by SAFE. Financiers and project sponsors have long appreciated this. In spite of this, many financiers, having being hurt by the recent spate of bad or problem debt cases involving Chinese enterprises, have had to refresh their understanding of the many foreign exchange rules that determine whether foreign currency can be converted and repatriated to them when faced with a defaulting or financially distressed Chinese customer.

To generalize, foreign currency financings for projects would involve two distinct yet inter-related foreign exchange control pre-requisites, namely, SAFE approval without which loan facilities are invalid, and registration of the foreign currency debt with SAFE.

Financiers have found that if any defects or vagueness in the text of the SAFE approval have been somehow passed over at the time such approval was issued (this is not unknown), this raises a valid concern as to whether the approval actually covered the case in question. Hence, in a default or enforcement scenario, a good argument can be raised to the effect that the relevant SAFE approval did not extend to certain aspects of a project finance transaction, and by then it will normally be too late to rectify matters.

For future project financings, especially those with third party security providers, it will be essential for financiers to examine the text of the SAFE approval thoroughly for themselves. It is common for SAFE approvals to be worded loosely, and a suggested answer to this dilemma is to have an appropriately worded Chinese text drafted by lawyers provided to SAFE at the approval application stage.

On the other hand, all foreign debts need to be registered with SAFE. This is not to be confused with the need, as is often the case, for SAFE approval which, as described above, is the primary requirement. The failure to obtain a SAFE foreign debt registration certificate will not in itself invalidate the subject loan financing. Rather, without such a certificate, a Chinese borrower in a project financing will not be able to convert renminbi into foreign currency to repay its indebtedness to foreign financiers.

While the provision of a SAFE foreign debt registration certificate is a must to ensure full protection for financiers, the content of such a certificate does matter. As in the case of SAFE approvals, the Chinese text of the debt registration certificate needs careful examination on its issuance to ensure all relevant details are correct. Where financiers or financing terms have changed during the term of the project loan, these changes will require noting on the existing debt registration certificate.

If, indeed, the debt registration with SAFE was not made, there is a procedure for performing this, but financiers and project companies need, however, to be forewarned that any retroactive registration will be subject to considerable scrutiny by SAFE. The project company or borrower with the task of pursuing the registration will need to pay an appropriate penalty for failure to register and, at the same time, an accountant's capital verification report in respect of the borrowings as well as a legal opinion in respect of the loan document will need to be provided to SAFE.

SAFE's recent practices or changes in practices have imposed more extensive currency conversion requirements, and financiers and sponsors alike should certainly take full cognizance of these requirements if the project concerned is to pass SAFE's scrutiny. A number of key tests to be applied by SAFE come to mind:

(1) The aggregate amount of medium and long-term foreign debt may not exceed the difference between the total investment amount and the approved registered capital;

(2) The project company's registered capital must be fully paid up; and

(3) The project loan's interest rate should not in principle exceed the prevailing interest rate for similar loans in the international financing markets.

The above issues aside, there is always the issue of the level of support on currency convertibility that the local or provincial government or other authorities (including financial institutions) could provide to allow foreign financiers to be

sufficiently comfortable. This may not be forthcoming in many cases although, in the BOT projects to date, financiers have been provided some measure of comfort (including in some cases from SAFE directly) on this issue.

Even though all procedures may be satisfied to ensure full conversion and repatriation of foreign currency abroad, one of the lingering worries for financiers and sponsors remains the risk of renminbi devaluation. From time to time, the Chinese government would pledge to support the stability of the renminbi, yet many bankers view devaluation as a real risk which needs mitigating in a number of ways, including by indexing the relevant part of the pricing mechanism or tariff to compensate for downward fluctuations in the value of renminbi. The legal basis for this type of adjustment remains questionable under Chinese law. The issue of renminbi devaluation can also be mitigated somewhat by sourcing increased levels of and longer term renminbi financing.

## G. USE OF RENMINBI

While foreign currency financing remains an essential requirement for Chinese projects, renminbi financing continues to form an integral part of the business requirements of Chinese projects. The past few years have seen an increasingly strict regulatory framework to control a project company's use of renminbi and ability to tap renminbi financing. The ability of project companies to obtain renminbi funding is now of considerable importance in light of the downturn in the (foreign currency) project finance market in China.

The People's Bank of China and SAFE issued several notices in 1998 which imposed restrictions on the use of renminbi loans, in particular, the use of renminbi loans to repay or prepay foreign debt. These notices include:

(1) Notice on Strengthening Administration of the Verification and Approval of Repayment of the Principal of, and Payment of Interest on, Foreign Debts issued by SAFE on June 22, 1998;

(2) Notice on Relevant Issues Concerning Prohibition of the Purchase of Foreign Exchange for Prepayment of Loans issued by the People's Bank of China and SAFE on August 20, 1998; and

(3) Notice on Strengthening Administration of the Business Where Financial Institutions in China Grant Renminbi Loans Secured by Foreign Exchange issued by the People's Bank of China and SAFE on September 26, 1998.

Under these notices, there are restrictions regarding the prepayment of foreign debt, and these include:

(1) A prepayment is not allowed unless otherwise specified in the loan agreement; and

(2) A borrower may only use its own foreign exchange to prepay the loan on approval of SAFE. It is not permissible to use renminbi to purchase foreign exchange for prepaying a foreign exchange loan, and a renminbi loan cannot be used to prepay a foreign exchange loan.

There also are restrictions regarding the repayment of foreign debt, and these include:

(1) Renminbi loans cannot be used to purchase foreign exchange for loan repayment;

(2) A borrower or project company is prohibited to purchase foreign exchange for loan repayment in places other than where the borrower or project company is registered;

(3) If the amount of repayment exceeds US $1 million, SAFE shall examine and investigate the foreign exchange purchase for repayment purpose; and

(4) A borrower is only allowed to purchase foreign exchange with renminbi for loan repayment after first using up its own foreign exchange funds.

Although a project finance agreement usually contains prepayment provisions, a Chinese project company borrower may still not be able to prepay its foreign exchange loans if it does not have sufficient foreign exchange reserves. The Notices also suggest that renminbi loans are only available for short-term working capital purposes or where there is a new project.

In planning for renminbi financing, an ongoing concern (justified or not) for foreign financiers is that renminbi financiers somehow end up with prior security interest over foreign financiers. Under the Administration of Project Financing Conducted Outside China Tentative Procedures (April 1997), renminbi loans must rank *pari passu* with foreign currency loans.

In a properly structured project financing agreement, both foreign and local financiers should be contracted to share the security available in an equitable manner. Such inter-creditor considerations between foreign currency and renminbi financiers can represent a challenge to the parties concerned, but it remains important for foreign financiers to sufficiently tightly or closely monitor the level and extent of renminbi funding and security extended to renminbi financiers.

## H. BUILD OPERATE TRANSFER (BOT) AND THE WAY FORWARD

The Chinese government has, in the past few years, been attempting to find a generic solution to financing infrastructure projects acceptable to project sponsors, financiers, and itself. The BOT concept remains China's pilot program in this direction.

To date, only a handful of projects, starting from the Laibin B power project in Guangxi province, have utilized BOT principles.

However, with so many projects requiring funding and each project taking on unique characteristics, it would be highly impracticable for the BOT model to be applied on a generic basis across project financings in China. Nonetheless, the development of BOT principles, albeit slowly, is significant in a country with such vast potential for foreign sponsors and financiers.

China's BOT principles encourage provincial or local governments to invite international developers to make competitive bids for projects under the overall supervision of SDPC. This competitive bidding scheme is based on international standards and allows wholly foreign-owned interests in the project, coupled with a concession agreement with the provincial government and some assurance of renminbi convertibility, to lie at the heart of China's BOT concepts.

The law on BOT in China remains in its infancy and is spelt out in a number of basic circulars, such as the Circular to the Ministry of Foreign Trade and Economic Cooperation on Several Issues Concerning the Absorption of Foreign Investment by the BOT Method (MOFTEC BOT Circular) issued on January 16, 1995, and the Several Issues Concerning the Examination, Approval and Administration of Experimental Foreign Invested Concession Projects Circular (BOT Circular) issued by the former State Planning Commission, the former Ministry of Power Industry and Ministry of Communications on August 21, 1995. With the long expected and more extensive "BOT Law" yet to be promulgated, BOT principles remain dictated by these Circulars.

The MOFTEC BOT Circular authorizes the use of BOT in project financing on a trial basis, but all investments relating thereto are required to comply with MOFTEC approval procedures that are applicable to other forms of foreign direct investment. These include examination and approval of the project company contract and articles of association, and ministry-level approval if project investment exceeds the local approval ceiling.

A further requirement is that the foreign concessionaires should be qualified in terms of technology, creditworthiness, and BOT expertise. The MOFTEC BOT Circular prohibits issuance of government guarantees or commitments with respect to foreign exchange and loan repayment without the approval of the relevant departments of the central government.

The BOT Circular, on the other hand, provides the requisite regulatory background for concession-based BOT project financing. Under the BOT Circular, the BOT project company can be organized as an equity joint venture, a cooperative joint venture, or a wholly foreign-owned enterprise. As the BOT structure is still in a trial process, it is only available in the following projects:

(1) Coal-fired power plants with a capacity of 2x300 MW or more;

(2) Hydroelectric power plants with a capacity of less than 250 MW;

(3) High-grade highways with a total length of 30 kilometers to 80 kilometers;

(4) Separate bridges with a length of more than 1,000 meters;

(5) Separate tunnels; and

(6) Urban water supply plants.

Under the BOT Circular, a number of key points stand out, such as:

(1) The state will guarantee the conversion of foreign exchange required for the project company to repay principal and interest on loans and to remit dividends out of China;

(2) The government cannot provide any guarantee for a fixed return on investment; and

(3) Neither financial nor non-financial institutions in China may provide guarantees for the financing.

The BOT Circular further states that a preliminary feasibility study is first prepared by the relevant local planning department and relevant industry department, then submitted to the department in charge of the industry and SDPC for approval. State Council approval is necessary where the project investment exceeds US $100 million.

Feasibility studies for BOT projects under China's BOT principles need to contain information on project details, engineering, technology, and environment protection, and the following information:

(1) An analysis of market demand;

(2) The total investment amount;

(3) The fulfillment of external conditions;

(4) An economic and financial analysis;

(5) The initial charging standards;

(6) The principles of price adjustment;

(7) The terms of concession;

(8) The principles of risk sharing;

(9) The associated facilities to be supplied by the government; and

(10) The obligations to be assumed by the government.

After the preliminary feasibility study is approved, under the BOT principles, an invitation to tender is prepared by the relevant local government. This would normally contain drafts of the key project contracts, namely the concession agreement, the off-take contract, and the supply or transportation agreement, as the case may be. Competitive bidding then takes place. An evaluation committee, supervised by SDPC, oversees the bidding process and evaluates the bids. The winner, whose selection is based on, amongst other things, technical merit and level of tariff, will negotiate the concession agreement, which needs to obtain approval from the SDPC (or State Council, as necessary).

After execution of the concession agreement, certain formalities need be complied with by the project company, such as registration with the relevant Administration of Industry and Commerce, and MOFTEC approving the project company's articles of association. The project company's obligations and stated purpose will be to invest, finance, construct, operate, and maintain the project under the concession extended to it.

As mentioned above, BOT remains a pilot scheme, and it is moot whether the scheme would work well in the Chinese context as a blueprint for future projects. This has not, however, prevented financiers and sponsors from borrowing and applying BOT concepts to other project financings in China and successfully closing these financings.

While principles enunciated in the BOT Circulars would appear to offer less flexibility to sponsors and financiers and less opportunities of a working relationship (and therefore relationship building) at an early stage with the Chinese parties, these BOT scheme financings did come with a concession agreement and a relatively strong government-supported package. Contrast this to a negotiated project financing, which is favored by many project participants, since there is more control and influence over the specifics regarding the project and the financing.

## I. CONCLUSION

The key risks in doing project finance in China described above have been explored in a number of project financings involving export credit agencies, which have been a driving force in producing better solutions in the context of a troubled Chinese project finance market.

Notwithstanding this, the vast potential of the Chinese market and the willingness of the Chinese government to continually improve its law and legal system should mean that, for years to come, the Chinese project finance market has the potential to considerably increase its attractiveness to foreign participants and financiers alike.

# Appendix I

## Key Governmental Institutions Involved in Project Finance

| | |
|---|---|
| • Local government planning department | • project proposal and feasibility study report |
| • Government department in charge of relevant industry | • main project documents and of setting up of project company |
| • State Development and Planning Commission (SDPC) | • main project documents and approval of setting up project companies |
| • Local commissions for foreign trade and economic cooperation (COFTECs) | • setting up of project company for investment lower than US$30 million |
| • Ministry of Foreign Trade and economic Cooperation (MOFTEC) | • setting up of project company for investment exceeding US$30 million, and issue of import and export licences |
| • State Council | • "major" projects with investment exceeding US$100 million |
| • State Administration of Industry and Commerce (SAIC) | • business licence of project company |
| • State Administration of Foreign Exchange (SAFE) | • financing terms and foreign exchange controls |
| • Local environmental protection bureau | • Environmental review at preliminary feasibility stage |
| • Local labour bureau | • employment permits for expatriate personnel |
| • Customs bureau | • exemptions and reductions where applicable and obtain clearance |
| • Local tax bureau | • tax concessions and holidays applicable to project in specific industry |
| • Local water resources bureau and construction commission | • rights on waterways and landing rights |
| • Land administration bureau | • land use rights |

## CHAPTER 7
# PROJECT FINANCE — THE GERMAN VIEW

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## A. INTRODUCTION

The pure form of project finance is a project which can be financed out of itself, i.e., out of its projected revenues sufficient to service any loans. However, often there are other lenders, besides primary lending banks, contributing to it. The sponsors give the required equity, certain guarantees, or letters of patronage, and public funds under the classification of development aid and export credits are used, while the host country's government may grant concessions. The resulting mix is a veritable bouquet of flowers, meaning sources of finance must be assembled, which is a time consuming work. Additionally, this paperwork must be drafted and checked by outside and in-house legal experts. If German law is involved, documentation is normally considerably shorter as compared to an Anglo-American set of documents.

"Project finance" translated in German is *Projektfinanzierung* and is regarded by some writers as a *terminus technicus*. However, it can cover all types of projects and expected revenues are in various forms, e.g., Build Operate Transfer (BOT) or Build Own Operate Transfer (BOOT), to a municipality planning to construct a new city hall and whether to outsource the city administration; to an unincorporated group of private persons wanting to build and run a new supermarket. A similarity exists between a toll road or an airport on an original BOT basis; a toll road may remain in the hands of an official authority but is operated by a third party, lease basis, or is controlled and operated by a private party. The difference lies primarily in the applicable rules of procurement, risk sharing, and sources of finance.

## B. GERMAN PROJECT FINANCE

Most academic literature on project finance is primarily written in English, rarely in German. There may be some translations of English documents on project finance, but caution should be heeded in reading the translations. Translations of documents should be non-binding and for information only. Some countries will also insist on their native language for documents, e.g., Libya, where the originals must be in Arabic and always starting with the beginning of the first *Sura* of the Koran — *Fatah*. However, some European states have also passed general regulations as to the use of their native language in contracts. The great majority of international

project documentation would use English as the original and binding version and English law and jurisdiction or the law of the State of New York and corresponding venue is convened as applicable.

However, this situation is changing, and many German lawyers are well versed in English and English law and jurisdiction. German legal literature is scattered, and there is still no standard textbook covering all aspects of projects and project finance.

Large German banks have set up special departments to deal with every aspect of project finance in the broad sense so that they may properly advise their clients, but also to evaluate the credit risks involved. German industrial companies often have their experts grouped into separate departments or in the form of a specialized subsidiary. Their objective is to do the fact-finding about new projects, work on tenders, negotiate relevant contracts, and supervise the project finance team.

For German consulting engineers, project finance is an old acquaintance although these activities are relatively new in Germany, as before 1945 there was not a significant number of internationally accepted independent consulting firms. This situation has changed in the interim, and German consulting engineers are operating and respected worldwide.

The Federal Government has also shown a growing interest in the subject. The former Federal Minister for Economic Cooperation admonished German project financiers in 1999 by not investing large amounts in BOT projects in the Third World and, indeed, according to German press reports, he missed the chance.[1]

However, his successor offered government assistance with subsidized training courses for Africans and other Third World inhabitants.

The newly appointed Federal Minister of Finance vividly supports, for obvious budget reasons, any Project Finance Investment movements which in fact still remain exceptional. Some observers say that this is so because some government or municipal officials fear to lose board membership and compensation. Decisions by city councils of course depend on the view of the ruling political parties' representatives and political ecologists.

Since August 1994, there is a special German law on the private financing of the construction of toll motorways and tunnels.[2] Work on the first tunnel, near Rostock on the Baltic Sea, under this law has started only five years after the coming into force of the Act in early December 1999. The general contractor was a well-known French construction company and the shareholder of the respective SPV a Norwegian fund.

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1 *Frankfurter Allgemeine Zeitung*, October 25, 1999.

2 Official abbreviation: FstrPrivFinG.

More than 160 years ago, the construction of railways formed the subject of a special Prussian Act,[3] prescribing the legal form of a joint stock company for any project company, limiting the tariffs so that the company may show a net profit of between six per cent and 10 per cent and allowing the state to take over the project company after 30 years against adequate compensation, making it a predecessor of BOT models.

The financing of projects as such is not new, be it domestic or international. Today, it is highly interesting to look into the files of project financing in the pre-World War I period. There were many railway constructions from China to the Americas, Suez Canal, or the mining industry. Government concessions were granted, special companies formed, bonds issued in the international capital markets, completely free in those days, and now available as beautifully engraved non-valuers (a collector's item). Some projects were never finished; some were expropriated or nationalized and some are still functioning, like the Panama Canal.

One still can learn from the fate of old projects, which often depended on the changing political situations of the project country. German companies, banks, politics, and politicians are no exception to learn from. The famous chancellor Bismarck was involved in a German-built Baghdad Railway originally owned and operated by the *Anatolische Eisenbahngesellschaft*.[4] This railway still functions in major parts and also makes up part of the Turkish lines to be privatized.

Many sections of society regard project financiers as "colonialists". This happened on the German-built *Cabora Bassa* hydro electric project on the Zambesi where the Portuguese government gave its guarantee and had to pay under this guarantee. The guarantee's terms were applied, even after Mozambique gained its independence and the long-term supply agreement with the South African ESCOM could not start as a civil war broke out.

## C. IMPLICATION OF DOMESTIC LAW AND EUROPEAN DIRECTIVES

In Germany, quite a number of new laws have been passed in recent years which are connected with projects and project finance. The laws on the private financing of toll roads and tunnels follow the Ordinance on the Federal Budget, which obliges the administration to examine whether and to what extent public duties might be handed over, including privatizations, to private persons.[5]

Within the European Union (EU), a number of Directives were enacted on the coordination of different activities of construction, deliveries, sectors, and services which, in the course of time, were changed and amended. Important Directives,

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3 Prussian Act, November 3, 1838 [sic].

4 The railway was purchased by the Turkish Government in 1924 for US $400 million.

5 Federal Budget Ordinance, section 7.

including the Brussels Directives on Procurement,[6] were passed after the EU became a member of the General Procurement Agreement.[7]

In the past, tenders for projects of the federal and state government and municipalities and their agencies were considered as part of our budgetary law which was reformed in 1993. However, the law did not give any specific legal rights to the bidders, including claims for damages against the state, which might be enforced by going to court under our administrative law. The European Court in Luxemburg heavily criticized this as well as the representatives of the United States government.

Consequently, a new law on procurement was enacted applicable as of January 1, 1999 regulating public tenders by the government exceeding fixed minimum amounts.[8] This Act, which shall assure fair competition, is contained as a new chapter in the Act on Unfair Competition, and opens the way to appeal to a new "Procurement Chamber" (*Vergabekammer*) and possibly to go to the competent civil court of appeal.[9] Some cases have already come up for further scrutiny.

Since the early 1920s, two of the original privately organized procurement committees were established in Germany: one for construction and another for services. Originally, their purpose was to define the rules to be applied to construction and service contracts negotiated between private suppliers and the government, called *Verdingungsordnung*. Now, there are three different sets of such rules: one for construction and building (*Verdingungsordnung für Bauleistungen*), one for services (*Verdingungsordnung für Leistungen*), and a new third for the service of experts like architects (*Verdingungsordnung für freiberufliche Leistungen*).

The rules apply in case of government procurement, including federal, state, and municipal procurement.[10] This also includes government owned or controlled but separate legal entities which should be in the public interest and in line with the budgetary law. A new EU Ordinance on procurement is in the process of being worked out. It will also refer to these *Verdingungsordnungen*. These rules have not the force of law but are published in the *Federal Gazette*.

Official tenders are announced in Germany three times a week in a special gazette, the *Bundesausschreibungsblatt*, and in other at least newspapers with local circulation. Such announcements must observe the rules as to the contents of the tender.

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6 Brussels Directives on Procurement 97/52/EWG — 98/4/EWG.

7 Brussels Directives on Procurement 89/665/EWG — 92/13/EWG.

8 Vergaberechtsänderungsgesetz, August 26, 1998.

9 Unfair Competition Act, sections 116 *et seq*.

10 Unfair Competition Act, section 98.

## D. RULES OF CONDUCT

The fight against bribery and corruption in the context of procurement is a topic which many countries are addressing.[11] The media report many unfortunate cases around the globe, e.g., Hubco Pakistan BOT project or the Lesotho dam.

The remarkable activities of Transparency International should be mentioned in this connection. The last chairman was a Nigerian, General Olesegun Obasanjo, who is now the President of Nigeria and has actually started the fight against the widespread corruption in his country.

Corruption disrupts fair competition, and it is a misuse of public funds and should be branded as a criminal act, whether at home or abroad. In Germany, a new law was enacted in 1997 and new sections in the Penal Code to fight corruption.[12] The German parliament decided after lengthy and hot discussions that any sums paid in bribery may no longer be used as a tax deductible expense and, in any case, cannot be covered by government export credit guarantees.

The Organization for Economic Co-operation and Development (OECD) has formulated a convention containing some rules of conduct.[13] Germany acceded to the convention by an Act of 1998, effective February 15, 1999. In addition, other organizations have conduct rules: UNCITRAL, the EU's Joint Common Service Relex Manual of Procedural Rules, the World Bank, and the IDA (anyone found guilty of corrupt practices may be excluded by a sanctions committee from participating in tenders for World Bank and IDA financed projects), the International Chamber of Commerce, and the Federation of German Industry. The International Federation of Consulting Engineers (FIDIC) has issued a code of ethics.

A number of large German industrial companies, e.g., Bosch and Siemens have already worked with trade unions concurring internal guidelines strictly forbidding any use of bribery in connection with project procurement. Any contravention will have the consequence of immediate dismissal and could be treated as a criminal offence.

Transparency International propose that German government export credit guarantees, Hermes cover, and investment guarantees might be jeopardized if corruption is involved. This subject is under discussion by the OECD working group.[14] Meanwhile, the rules have been amended accordingly.

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[11] United States Foreign Corrupt Practices Act 1977; International Bribery Act 1998.

[12] Penal Code, sections 298 *et seq*.

[13] Organization for Economic Co-operation and Development Recommendation C (97) 123/Final, text 36 ILM (1997), at pp. 1016 *et seq*.

[14] "Transparency International", *Deutschland Newsletter*, Number 12, 1999, at p. 6.

German courts have yet to decide to what extent project contracts can be rescinded or become partly or totally null and void if bribery has been used to win a procurement contract. Only one case has been heard by the Federal Court which was sent back to the Court of Appeal for further review of the salient facts. Nevertheless, the Federal Court found that, in principle, a contract with an architect could be valid although bribery was involved, but it may be voidable.[15] The other party was a non-government organization.

## E. CONFLICT OF LAWS

Domestic, foreign, and international projects need to differentiate between government and private projects. Obviously, domestic law applied for domestic projects, but the question remains as to whether conflicts should be brought to the local courts, which appears to be the rule, or whether an arbitration clause should be agreed on.

Usually, a special legal entity, in the form of a company or sometimes a partnership, is created by parties interested in a project. Much depends on the tax and balance sheet consequences. German law provides different ways in which to implement a project. There is a certain preference to use a general contractor for a turnkey project, but also the formation of a consortium is often used.

Government authorizations are lengthy procedures, and sometimes it takes years before all competent authorities have given their final approval which is particularly so with atomic power plants and the handling by the administrative courts. To save time, work often is begun on the basis of a preliminary permit. Thus, law extensively regulates building and construction projects. Environmental protection also provides problems and delays. If neighbors to the site of the proposed project object to the level of noise and air emissions, and then take the case to court, it will eventually lead to further delays in the project's implementation. The time element is hard to predict but must be taken into consideration when drafting cash-flow projections as price increases are a natural consequence of such delays.

Under German law, the respective *Verdingungsordnung* will apply in case of government contracts. The rules of *Verdingungsordnung* also contain, in Part B of the Act, general conditions governing the standards of execution of works and services and are open for review by the courts under the General Conditions of Contract Act.[16] These rules may be separately agreed for private projects like other general business conditions.

For international projects, German law does not present any major difficulties. However, a number of specific German Acts must carefully be observed, e.g., the

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15 BGH VII ZR 132/97, May 6, 1999.

16 Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen, December 9, 1976, incorporating European Community Directive 93/13/EC.

Foreign Trade Act (*Außenwirtschaftsgesetz*) and its ordinances on embargos with countries like Yugoslavia and on the export of weapons and other war material including the difficult subject of dual-purpose goods. Since the Federal Republic of Germany became an "Article VIII country", it has always followed and supported the principle of free flow of capital as an essential condition for further private foreign investments.

In principle, Germany is free as far as the choice of law is concerned and submission to foreign jurisdiction, including arbitration, as long as the *ordre public* is observed.[17] In German legal literature the question of *dépecage* has been hotly discussed since quite a number of contracts have to be entered into besides the master agreement, and the laws of different countries may be applicable. It is up to the parties to decide on the choice of law and venue.[18] However, in practice, there is the tendency to use the law agreed on in the master agreement for the other contracts.

## F. GOVERNMENT SUPPORT

The government provides many forms of support for new projects. Such support may be in the form of financial assistance and risk coverage through guarantees. For domestic projects, federal, state, and local government support has different means available to support new ventures under special programs, e.g., by way of grants under regional development programs for the former German Democratic Republic states. A recent example is of a new Volkswagen factory in Saxony where grants were given which, according to Brussels, were contrary to the respective EU rules and which should be returned. Other programs may concern the creation of new employment or low-interest loans by the *Kreditanstalt für Wiederaufbau* or state organizations *Landesaufbauanstalten*. Normally, such loans are channeled through private credit institutions, which in turn contribute some further funds out of their own means. In some cases official sureties may be obtainable.

Further assistance for projects in Germany could become available as in other Member States of the EU from or through the European Investment Bank, the European Community for Coal and Steel, or the Council of Europe Social Fund and further comparable international organizations, such as the FAO, the UNIDO, or the Center for Industrial Development (CDI) under the *Lomé* treaties.

Similar to other industrialized countries, Germany's official funds are available for projects in the Third World. Such development assistance in line with the "DAC Guiding Principles for Associated Financing and Tied and Partially Untied Official Development Assistance" can take many different forms and different conditions, provided the project can be judged as a valuable contribution to the economic development of the host country and corresponds to its requirements. In this context,

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[17] EGBGB, article 6.

[18] EGBGB, article 27, which is in line with the respective European Convention.

questions of environment protection in the host country are often discussed rather critically, labor conditions, and possible negative consequences for domestic employment.

In contrast to other countries, German development assistance is in principle untied. The Federal Ministry of Economic Cooperation and Development plays a decisive role in this context with an annual budget of more than DM 7 billion. Besides contributions to multilateral institutions like the World Bank, the IDA, and the IFC, the actual loans are handled in the Federal Republic of Germany by three institutions created and owned by the government: Frankfurt-based *Kreditanstalt für Wiederaufbau, DEG Deutsche Investitions- und Entwicklungsgesellschaft*, and *GTZ Deutsche Gesellschaft für technische Zusammenarbeit*. All three are heavily engaged in the evaluation and support of projects including export credits and tied financial credits by German banks under the aspects of development assistance, and they cooperate internationally with their foreign homologues. In practice you will often find combinations of international or other foreign financial organizations.

Only the *Kreditanstalt für Wiederaufbau* may, under certain conditions, give grants in line with the DAC Consensus and credits at reduced rates and mix these with credits out of their own funds.

## G. EXPORT CREDIT RISK INSURANCE

For almost all types of foreign and international projects, the export credit risk insurance is of the utmost importance. Some coverage may be obtained from private insurance companies. In Germany, the typical export credit risk guarantees are handled by the privately owned Hermes insurance company as an agent of the federal government, known as "Hermes-cover". From 1993 to 1997 Hermes-cover insured 142 large projects, each exceeded DM 100 million. A German exporter or a German credit institution may submit an application on the prescribed forms.

The decisive body is an Inter-ministerial Committee (IMA) with official members and some members from German economic circles. The Hermes conditions should correspond to the OECD "Arrangement on Guidelines for Officially Supported Export Credits". If and to what amount and lifetime Hermes cover will be given depends on a number of criteria as fixed by the committee from time to time. Hermes regularly publishes country classification numbers, e.g., 1 Australia to 7 Angola.

Hermes covers the political risks, including the very important convertibility and transfer risks and the economic risk of the foreign importer. A guarantee can be obtained for the manufacturing period until the goods are actually exported (*Fabrikationsrisiko*). This includes embargo risks whether German under the Foreign Trade Act or foreign, and it covers risks after the time of delivery (*Ausfuhrdeckung*). Foreign subcontractors may be covered, in the case of EU suppliers up to 30 per cent to 40 per cent. Special types of coverage are offered in connection with bid bonds, prepayments, building and construction works, and construction equipment and leasing.

In the course of time, financing of the foreign importer will become more and more important, and a new instrument was developed to cover the corresponding risks of the banks for tied loans: *Finanzkreditdeckung*. It is interesting to note that such cover could be and in practice mostly is extended to 95 per cent of the outstanding amounts and the usual six months' waiting period shortened to three months in case the banks abstain from demanding security by the exporter for the uncovered portion.

In principle, the exporter does not have the right to apply for coverage of only one or the other risk. In case the foreign importer is a subsidiary of the German exporter the insolvency risk will not be covered. In the case of BOT projects, all risks should be covered, but Hermes may exclude some specific risks like the operator risk; following a 1988 ruling by the Federal Ministry for Economy, a detailed feasibility expertise by PwC Deutsche Revision must be submitted and paid for by the German exporter, and the fees are high.

## H. FOREIGN INVESTMENT RISK

Foreign investment risk concerns construction, materials, engines, cranes, equipment, vehicles, concessionary rights, foreign shares in the project company, and the special purpose vehicle. Foremost is the political risk of the host country and the investment climate, which has changed considerably in the last decade. Almost every country now understands that private investments and, in particular, foreign private investments are essential for the development of their economy and with more or less success have begun with privatization programs. The figures published in the annual DAC reports show that such investments now largely exceed the sums of official development assistance. The early days of nationalization after the "wind of change" blew are definitely over. However, discrimination of foreign investments still exists, transfer and convertibility risks keep increasing, and "Saint Burocratius" waves his scepter.

Germany is trying to safeguard investment and Hermann Josef Abs, the past chairman of *Deutsche Bank*, started in 1959 to build up a network of bilateral treaties of which Germany has concluded 125. Many countries have followed with more or less similar treaties and today a total of more than 1,500 are counted, the first being concluded between the United Kingdom and Mexico in 1826. As all these treaties come under public international law, they cannot be changed unilaterally as national investment laws by the respective legislator.

Typically, such treaties contain clauses of non-discrimination, most-favored-nation treatment, expropriation only by law and in the public interest, and against prompt, adequate, and freely transferable compensation. Protected capital investments include the property of chattel and immovables, shares in companies and other forms of participations, claims of economic value, know-how rights, technical procedures, goodwill, and public law concessions. Special clauses deal with the procedure to be applied for dispute settlement, including, in some treaties, regulation by the ICSID, as the Federal Republic is a signatory of the respective convention.

In principle, the existence of such a bilateral treaty is a precondition for obtaining a German government investment guarantee. Like the handling procedure for Hermes guarantees the German government has appointed PwC Deutsche Revision to act as its agent. In this case, only the political risks may be covered such as expropriation, war, or civil disturbance. Sometimes, combinations between export and investment guarantee, are used in cases of important projects. In passing it should also be mentioned that Germany is a member of MIGA. A certain problem still is to what extent indirect investments can be guaranteed, e.g., when a holding company for the participation in a special-purpose vehicle domiciled in a third country is involved; this is still impossible but is under discussion.

Where a foreign government is a party to an international project there one also will be clauses in concession agreements, which are binding on the government to an internationally acceptable standard. This also includes being bound to attend an international arbitration. According to the German view, such concessionary agreements are considered as "quasi public international law" as questions of sovereign rights also comes into play, but this is the field of *iure gestionis* and it is fully recognized by German courts. The United Kingdom and the United States have special laws dealing with this subject.

Investment protection provisions can again be found in multilateral treaties to which the Federal Republic of Germany is a signatory to, such as the respective treaties concluded between the EU and certain GUS states, the *Lomé* treaties and under the auspices of the WTO, GATT, TRIPS, and TRIMS. It is unfortunate that so far all endeavors to create a multilateral protection agreement within the OECD have not come to fruition, and this includes the famous MAI.

## I. CONCLUSION

The German government, as well as legal experts, banks, and industry, have fully understood the great importance of projects and project financing for the economy as evidenced by the figures I have mentioned in the beginning. Without project finance in the form of BOT and similar models not only the chances for Germany's export-oriented industry would be diminishing but also the economic development of countries in the Third World and the often requested transfer of know-how might be seriously hampered. In practice, the German view does not differ fundamentally from that of other industrialized nations, whatever the details may be.

# CHAPTER 8
# PRIVATIZATION ASPECTS OF PROJECT FINANCE IN GREECE

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## A. GENERAL

### 1. Privatization

Privatization has been part and parcel of a world trend that has placed greater reliance on market forces and less dependence on government in the allocation of resources. Privatization is defined as any movement toward a market-driven economy that reduces public ownership and control. Privatization represents a reversal of the process of nationalization that prevailed from the 1970s until the mid-1990s.

This chapter reviews and outlines some of the most important recent efforts of the Greek state to privatize major sectors of the economy of Greece.

Significant privatization programs have been undertaken in spite of the often fierce opposition of affected groups — labor unions and users of the subsidized products and services and contractors who consistently overcharge the state-owned companies. Nevertheless, because of their potential to increase efficiency and reduce corruption, privatization programs have become popular in Greece.

Privatization began in the western hemisphere in the late 1970s, as nationalized industries began to lose favor. Disenchantment with state enterprises grew as they began to be perceived as bloated, inefficient, and not up-to-date with modern technology.

Privatization has been driven by, among other things, the increasing globalization of the world economy and the pace of technological change. Several decades of rapid growth in international trade and investment have made competitiveness in international trade an essential factor in a nation's ability to create jobs, raise real wages, and generate wealth. As for many nations, including many countries in Europe, privatization has been considered as the only effective way of raising investment capital on favorable terms. Nevertheless, privatization is not an end in itself and is not a panacea for the various difficulties faced by the public sector in many economies of Europe. A mere change of ownership or the introduction of private management has not by itself paved the road to financial and economic efficiency.

Ideally, privatization should be an element of broader economic policy comprising deregulation and liberalization, with as much emphasis on improving the efficiency of retained State-Owned Enterprises (SOE) as on efforts to divest. Even when governments decide to continue state ownership of certain strategic assets, various measures can be implemented to improve efficiency and reduce costs. In other words, privatization is a complement to, not a replacement for, the other aspects of promoting commercialization, such as the emergence of greater numbers of new private businesses.

## 2. Purposes and Methods of Privatization

Some of the most commonly identified objectives for privatization programs are:

(1) Reducing the fiscal deficit;

(2) Raising revenue through asset sales;

(3) Generating additional tax revenues;

(4) Encouraging the return of flight capital;

(5) Promoting foreign direct investment;

(6) Deepening and broadening domestic equity markets;

(7) Boosting investor confidence;

(8) Increasing efficiency;

(9) Fostering competition;

(10) Improving the quality of goods and services; and

(11) Reducing the state's role in the economy.

Some objectives, such as reducing the deficit, can be the direct outcome of privatization. Others, such as increasing efficiency and productivity, are longer-term objectives that depend largely on what new private owners bring to companies.

There is no single strategy or method for implementing privatization. It depends on investor interest, on government capacity, and on identification of the sectors and enterprises most in need of new investment and improvements in efficiencies. Most countries have begun their privatization efforts by private sale or public share offerings selling small and medium-sized SOE in competitive sectors. These sales are simple and quick, involve little restructuring or post-sale regulation, and are politically of low risk.

However, a growing number of governments, including Greece, are opting to launch their privatization programs with sales of large, but poorly performing, utilities. These countries believe that the window of political opportunity to privatize

these utilities may only be briefly open. They further believe that the sale or divestiture of a major SOE may signal a commitment to investors and markets, and the economic returns of enhanced efficiency will outweigh the potential risks.

In many developing countries, however, privatizations have largely been through liquidation followed by a sale of assets. This occurs because most of the affected enterprises have been small and non-viable. Large firms in need of reorganization are more likely to be sold through direct negotiations, competitive bidding, joint ventures, or the sale of the core shareholding to a strategic investor.

Management contracts, leases, or concessions, as methods of privatizing management, are particularly beneficial to low-income countries with weak capital markets and banking institutions, limited investor interest, and weak regulatory capacity.

When management contracts (whereby the government pays a fee to a private company to manage the firm in question) are correctly drawn, the gains can be considerable, but they require good drafting and competent supervisory responsibility by the government.

Leases provide greater incentives to reduce cost and maintain the long-term value of the assets, because the private party assumes commercial risk and pays a performance-based fee to the government.

Concessions go even further; in return for a long-term lease, the holder assumes responsibility for capital expenditures and investments. Experience with this mechanism in developing countries is both slight and relatively recent.

As a prelude to sale, large firms may need to implement legal, organizational, and managerial changes, financial workouts, and personnel reductions. Although it is possible for smaller and medium-sized SOEs to be successfully divested without prior restructuring, changing management and settling the liabilities of the SOE are standard measures in successful transactions.

Letting the market decide the sale price through competitive bidding is the optimal method. Enterprise valuation is difficult in the best of circumstances and doubly so in developing countries. In these countries, information is poor, comparables are few, and the market is thin. Although some external or independent valuation is useful for setting a floor price and ensuring a fair process (particularly in countries with weak capital markets), technical methods are seldom successful in determining the market price of an enterprise. Overvaluation and unrealistic price expectations can delay the privatization process or even lead to valuations that bear little resemblance to what the buyer will pay.

Selling for cash is preferable to accepting debt even if this means a lower price. An outright sale severs the link between the enterprise and the state, and cash sales provide the liquidity needed to pay enterprise liabilities. Nonetheless, many countries have resorted to government-financed sales for debt because financial systems are not deep enough.

### 3. Legal and Political Environment

Privatization almost always involves some changes in a nation's legal system. As in other regions of the world, in Greece, legal reform has been an important key for the successful privatization of SOEs, especially with regard to the protection of property rights and the reliable enforcement of contracts. The assurance of equal treatment of foreign investors and domestic investors by the judicial system has been also important.

Legal issues permeate the whole privatization process, from preparation to implementation and follow-up. They occur primarily at the systemic (laws, regulations, and institutions) and transaction levels.

At the outset, existing legislation, as well as the legal status of the SOEs to be divested, must be analyzed to determine whether privatization is possible without amending laws or regulations and is compatible with the government's objectives. For example, laws may need to be enacted to abolish a monopoly; regulate or deregulate the oil, gas, water, or power sectors; strengthen the country's capital markets; authorize the transfer of the particular SOEs to the private sector; or organize the privatization process itself. Moreover, some SOEs may have a legal status that does not allow or facilitate divestiture, in which case a change to corporate status is required. Further, if the ownership of assets is disputed, the rights of the contending parties must be clarified. All these elements need to be addressed before privatization can commence.

Lawyers also will be needed during the implementation stage of a privatization plan, to draft agreements and to advise buyers and sellers prior to and during negotiations. Advice may cover such topics as avoidance of conflicts of interest (or the appearance thereof) for government officials and advisers; confidentiality agreements with bidders and other parties involved in the transaction; observance of due diligence under the difficult circumstances common to many developing countries; and the treatment of creditors of the SOE.

Following completion of the privatization transaction, legal safeguards are required to ensure that all parties comply with the terms of the privatization agreements and to develop effective mechanisms to enforce compliance. The regulatory framework may need to be fine-tuned to ensure that it is fulfilling expectations by allowing private enterprise to develop, while protecting the legitimate interests of consumers, competitors, and taxpayers.

### 4. Privatization Lessons

As is evident from successful experiences in Greece, privatization requires transparency, political support, a clear legal framework, a strong regulatory and structural framework, integration with overall macroeconomic and structural reforms, and a level playing field to attract foreign investment and create a strong role for equity markets.

For a government to maximize the value of its privatization efforts, it must retain external advisors, limit presale restructuring, keep sale conditions to a minimum, select the right sales method, create incentives for employees and small investors, and disseminate general information to generate interest in the sale. Governments that deviate from these principles lower the value of privatization.

To modernize plants, introduce new technology, and upgrade and expand infrastructure, developing economies will require large-scale and long-term investment. Most of these investments will have to come from the private sector, with a large portion coming from foreign investors. Attitudes toward foreign investment are shifting in Greece, moving away from hostility to foreign ownership of companies and assets, toward welcoming the revenues, technology transfers, and management know-how that foreign investment can bring.

## B. PRIVATIZATION IN GREECE — LEGAL FRAMEWORK

### 1. Introduction of the Term Privatization

Privatization has been a stated policy of the Greek government since 1990. In the beginning, it was a low-profile operation. Even the term chosen, "De-nationalization", signifies an attitude of restraint: it was considered less "aggressive" than the term "privatization". Evidently, it also signified a certain lack of resolve to pursue the policy and to take all steps needed for its implementation. With the adoption of Law 2000 in 1991 "On de-nationalization, simplification of the procedure of liquidation, strengthening of the rules of competition and other provisions" (Privatization Law), the Greek privatization program has entered a new phase, which has completely revamped the previous system.

The first serious steps of the privatization program began after the elections of April 1990. At that time, a conscious decision was made to approach the issue in a subtle way. The objective behind this decision was to avoid the real, or perceived, danger of public disapproval of the policy. As a consequence, no comprehensive rules for privatizing SOEs were enacted at that time. The creation of a "rigorous legal system" was avoided with the intention to create privatization rules later and according to the experience gained in the meantime.

Privatization proceedings of this period were governed by the general rules of civil and corporate law. In each particular proceeding, one had also to take into account the provisions of the respective call for bids for the company being sold. However, the legal significance of these calls was limited insofar as they usually contained a clause to the effect that the call constituted a simple invitation to submit offers to buy and did not constitute an offer to possible buyers.

This piecemeal approach of the first phase caused several problems. All attempts at privatization were made in a legal vacuum, with a lack of clarity and coherence in their objectives (whereas a more institutional approach could have created a "philosophy" of privatization as well as a set of relevant rules).

The fact was that in each privatization proceeding of this period, there was no certainty as to the applicable rules. The parties involved (seller, inter-mediator, bidders, company being privatized) were in no position to actually estimate their rights and obligations and to adjust their attitude towards the program of privatization accordingly. Evidently, the privatization process was hurt by this uncertainty.

## 2. Law 2000/1991

### a. *Introduction*

Eventually, the failure of the initial approach became evident, which brought calls for change. The new attitude finally prevailed and found its expression in the Privatization Law. With the enactment of this law there was a complete departure from the vagueness of the previous situation and substantial progress in clarifying the rules of the game.

Rules now existed for all possible forms of de-nationalization. The Privatization Law also displayed a sense of urgency: because of the widespread belief that the program of privatization was not moving as had been expected, any further delay, or the impression thereof, would have been a serious political liability. Therefore, strict time limits were prescribed in almost every step of the introduced procedures.

### b. *Field of Application*

According to article 1 of the Privatization Law, "de-nationalization" is defined as either the "abolition or merging" of SOEs, the transfer of such entities to the private sector (which is specifically called "privatization"), or the liquidation of debt-burdened SOEs.

For the purposes of the Privatization Law, public sector is considered to be as defined by article 1, paragraph 6 of Law 1256/1982. This law attempted to delineate the public sector as widely as possible. That definition of the public sector has since then been restricted. However, in this instance the definition was employed to determine the targets of privatization.

### c. *Inter-Ministerial Committee on De-Nationalization*

The Privatization Law provides for the establishment of the "Inter-Ministerial Committee on De-nationalization" (DEA is the acronym of the words in Greek). The DEA consists of the Minister of National Economy, Minister of Finance, and Minister of Development (all of them being the regular members), as well as the Minister in whose supervisory authority the SOE being privatized in each case belongs.

The DEA has the power to decide which entities are to be "de-nationalized" and the method to be followed in this respect. This procedure is triggered following a

proposal from the Minister under the auspices of whom an SOE is placed or (in the absence of such a proposal) from the Minister of Development, who is authorized by the law to have an overview of the process of de-nationalization. Following the decision of the DEA to de-nationalize a SOE, the latter is obliged to submit a proposal on the method to be applied for its de-nationalization.

Such a proposal is not binding on the DEA, which in any event will take the final decision. If no decision is taken by the DEA within 35 days of the submission of the proposal from the SOE, the proposal is considered as having been silently accepted. In the case of a debt-burdened SOE, the DEA may decide to privatize it by transferring the holding of the state to a cooperative to which at least 70 per cent of the employees of the enterprise belong, while at the same time writing off its debts, in whole or in part.

### 3. Means for Implementing De-Nationalization

Under the Privatization Law, de-nationalization of an SOE may be implemented in one of the following ways, i.e., abolition or merger, privatization, and liquidation proceedings.

#### *a. Abolition or Merger*

By virtue of a Presidential Decree issued following a proposal from the DEA or any of the competent Ministers, an SOE may be merged or abolished. Similar decrees are made to regulate all matters related to the merger or abolition, including the dismissal or re-appointment of staff that have become redundant.

The objective behind this method of merging SOEs is to reduce the costs of entities that otherwise will not be transferred to the private sector. It should be noted that, if the entities merged or dissolved have the form of a corporation, then the relevant provisions of company law apply (Codified Law 2190/20, as amended). The technique of merging or abolishing by virtue of a Presidential Decree is only applied to non-corporate legal forms.

#### *b. Privatization*

**I. Methods.** Under the Privatization Law, privatization is one of the possible means of de-nationalization. Article 5 of the Privatization Law establishes that privatization may be effected in one or more of the following methods:

(1) Sale of all or part of the shares of a *societé anonyme* or a limited liability company held by one or more SOEs, this being a straightforward privatization option;

(2) Flotation of all or part of the shares of an SOE through a public offering. This option has the advantage of transparency;

(3) Sale of particular assets of an SOE, separately or in groups, or as self-standing production units;

(4) Leasing of particular assets of an SOE for a specific time period, with or without an option to buy them at a later date at a price which can either be specified from the outset or agreed at such later date;

(5) Awarding a management contract with or without the option to buy the SOE; and

(6) Exchanging the total or part of the shares of an SOE, in which case an evaluation of the shares of the company to be exchanged with the shares of such SOE must be conducted by an independent (not acting as the intermediary to the exchange) financial advisor.

The last two options are deemed to be only a temporary phase and only in case election of one of the other forms is either not feasible or not in the best interest of the state at that particular moment.

II. **Process.** The forms of privatization under items (1) and (3), above, are effected through the special privatization procedure of article 9 of the Privatization Law or through a trade sale.

The special privatization is an auction procedure subject to particularly stringent time limits. Following the approval of the DEA to apply this procedure, the seller organization submits a petition to the Court of Appeals of the area where the privatized SOE has its registered office, to establish the minimum purchase price for the company or the particular shares sold. The hearing is set for not later than 30 days from the submission of the petition.

Within five days as of the submission of the above petition, two official appraisers are appointed by an act of the President of the Court of Appeals, who must submit to the court their written evaluation of the company, one day at the latest, before the date of the hearing. An intervention by a third party in the hearing (possibly creditors of the SOE privatized) is only allowed if submitted in writing to the court, at least one day before the hearing. The court must issue its judgment within 15 days as of the date of the hearing.

Following the decision of the Court of Appeals that sets the lowest possible price for the sale, the seller proceeds with the sale of the company or of the shares to be sold by a public auction. The starting price for the auction is the price set by the court. Details of such auction are ruled by article 46a of Law 1892/1990, as amended by article 14 of Law 2000/1991.

A trade sale may be effected following negotiations with the interested individual investors, either directly with the entity-seller or through a financial institution, acting as an intermediary. If such an intermediary is used, it will have the obligation

to solicit buyers and achieve the highest possible purchase price. Before negotiations take place, the entity-seller, or the financial institution acting as the intermediary, publishes an invitation for the submission of binding offers, which will be accompanied by a letter of guarantee. The process, time limits, and conditions of submission of the offers and relevant letters of guarantee are established by the invitation. For the application of this procedure, an evaluation of the SOE will have to be carried out by an independent financial advisor, who should not be the intermediary to the sale.

The form of privatization under item (2), above, raises the interesting possibility, when an SOE is privatized through a stock flotation, of granting shares of the SOE to its employees, pensioners, or the consumers of the SOE's products or services. Issuing of shares to these categories of persons is decided by the DEA, in a decision whereby all other details of such issue are determined.

#### c. *Liquidation Proceedings*

The third option for de-nationalization is a special liquidation proceeding. This is reserved for those companies that are not fit to be sold because of their debts.

## C. KEY LEGAL ISSUES RAISED IN PRIVATIZATION PROJECTS IN GREECE

### 1. In General

The Greek state has entered into concession agreements either in the absence of an *expressis verbis* authorization provided by law, in which case said agreements had to be ratified by law, e.g., Athens New Airport, Rio-Antirio Bridge, or Stavros-Elefsina Motorway, and such ratification was a condition precedent for the financial closing or only after passing a law providing for such an authorization, in which case ratification was not required, e.g., cellular telephony, research, exploration, and exploitation of hydrocarbons.

It has been proven in practice that the most successful method is that of the ratification of the concession agreement by law since it allows the maximum flexibility to determine the terms and conditions of the specific project, as well as to regulate matters that are demanded by the investor for the success of the project. So far as direct agreements are concerned, it should be borne in mind that the lenders to the concessionaires will no doubt wish to enter into direct agreements with the state.

The following cases reflect the choices of the Greek state to proceed with the privatization of certain public sectors. It is apparent from the information found below that despite the promulgation of the Privatization Law, which provided the tools for the privatization of SOEs, the Greek state elected in many other cases to proceed on the basis of an entire new legislation that regulated the activities of the SOE to be privatized and introduced also the form of the concession agreement depending on the nature of each project.

Having said the above, the following cases represent the most recent examples of privatization procedures in Greece.

## 2. Privatization of Three Regional Gas Distribution Companies

### a. Background

Under Law 2364 of 1995, three regional Gas Distribution Companies (EDAs, as per their Greek acronyms) invited those parties interested to pre-qualify for three open tenders for the subscription of 49 per cent in each of the Gas Supply Companies registered in the corresponding region of each EDA (EPA, as per their Greek acronyms).

The EDAs were formed by the Public Gas Company (Greek acronyms D.EP.A). The EDAs, have within their own areas the exclusive right to program, study, design, construct, own, operate, and exploit the low and medium-pressure gas distribution systems and to sell gas to all categories of consumers with consumption of less than 100 GWh per annum. Pursuant to the above law, each EDA issued a call for investors to participate in the establishment of a corresponding EPA by subscribing to 49 per cent of its share capital.

Each EDA will hold the remaining 51 per cent and will contribute to the corresponding EPA the right to use the low and medium gas distribution network constructed to date within its own area and the right to program, study, design, construct, operate, and exploit the gas distribution system, as well as the right to sell gas in each area it serves, subject to the terms and conditions of a gas distribution license, to be issued by the Ministry of Development in the name of the relevant EPA. Capital provided by the investor shall be used to carry out the objectives of the EPA, including development of the network. The investors will be granted specified management control rights in the EPAs.

### b. Key Legal Issues

During the process of drafting the amendment of specific provisions of Law 2364 of 1995, to attract the private sector, the gas distribution license, and the allocation of the grants, the following key issues were addressed which affected seriously the economics of the projects and, consequently, the ability of project financing.

The gas distribution license had to be issued in the name of the EPAs instead of in the name of the EDAs, as Law 2364 of 1995 provided in the first place. This was an important issue since the EPA would be operating the network and would be responsible to abide with the conditions of the license, and a default by the EDAs could result in the revocation of the license.

The payment of compensation by the Greek state for any license amendment or revocation was other than in accordance with its terms. The Greek state rejected the

idea of having an agreed compensation mechanism applicable in such cases. Therefore, the investors will have to file a lawsuit against the Greek state before the Greek courts to seek damages, and the investors have identified the risk in this particular case and considered it in submitting the bid.

The ownership of the low-pressure network constructed by the EPAs should have been vested to the EPAs. Under Law 2364 of 1995, the EDAs (the shareholder of the EPAs) will own their new network constructed by the EPAs and, only the right of use will be given to the EPAs. Potential investors questioned this unique procedure since it affected the financing of the project.

The introduction of a compensation mechanism in the event that tax changes on gas or competing fuels affects the competitiveness of gas. State guarantee of the availability of the grants. Clarification on tax treatment of the EPAs.

Securing true management control of the investor in the EPAs was an issue since the 49 per cent ownership did not provide, *per se*, full management control. The license period was set for a period of up to 30 years, which was not to the satisfaction of the investors. State guarantee for the protection of the investment and the stability of the regulatory regime also was required. An application of arbitration instead of recourse to the Greek courts was preferred.

### 3. Privatization of the State-Owned Water Company

The privatization of the State-Owned Water Company (E.YD.AP, as per the Greek acronyms) was triggered by virtue of Law 2744 of 1999 that provided the sale of up to 49 per cent of its shares.

The privatization of E.YD.AP required a full restructuring of the regulatory framework, assets classification, settlement of taxation matters, provision of contractual relations between the Greek state and E.YDA.P for the provision of water and a number of other interventions and amendments of existing legislation, all of which were included in Law 2744 of 1999. The following issues were addressed:

(1) Restructuring of E.YD.AP. Severing of the right to provide water and sewerage services (which stays with E.YD.AP) from ownership of certain public utility infrastructure (pipelines, water depots, or water reserves), which is transferred by operation of law to a separate public law entity, established by the same law, to hold and control such strategic assets;

(2) Redefinition of the legal status of E.YD.AP. Switch from a public entity of public law to a public utility entity of private corporate law;

(3) Broadening the business activities of E.YD.AP, as defined in the original statutes;

(4) Stating the rights and obligations of E.YD.AP, and the duration thereof, such rights not being capable of concession or transfer;

(5) Provision for the disposal of outdated or surplus materials by E.YD.AP;

(6) Determination by Ministerial Decisions of the invoicing policy to be followed;

(7) Requiring an inventory of E.YD.AP's assets to be formed and the clarification of such assets' ownership status;

(8) Definition of state obligations to provide, by contract between the State and E.YD.AP, the use of the infrastructure and of water to E.YD.AP. Determination by the same contract of the fees to be paid by E.YD.AP for such provisions; and

(9) Granting of privileges (tax concessions, legal protection of E.YD.AP properties).

### 4. Research, Exploration, and Exploitation of Hydrocarbons

#### *a. Background*

The privatization of the activities of research, exploration, and exploitation of hydrocarbons was effected by virtue of Law 2289 of 1995. The exercise of the right of research, exploration, and exploitation of hydrocarbons that exist in onshore areas of Greece and in offshore areas of lakes and seas, is vested exclusively with the Greek state and is always considered to be for public benefit.

The Greek state or the Public Petroleum Corporation — Exploration and Exploitation of Hydrocarbons S.A. (DEP — EKY) conceded the rights of exploration for and exploitation of hydrocarbons by contract following a public bid. The right of exploration and exploitation of the Greek state was conceded through the conclusion of:

(1) A lease contract; or

(2) A production sharing contract, in which both cases the stage of exploration and the stage of exploitation are provided.

The selection between the types of contract that were concluded for each contractual area was determined by decision of the Minister of Industry, Energy, and Technology on the recommendation of DEP-EKY.

The criteria for the selection included the royalty offered by the interested parties, in case of a lease contract and the participation interest of the Greek state or DEP-EKY on the hydrocarbons to be produced, in case of a production sharing contract.

*b. Key Legal Issues*

During the process of drafting the provisions of Law 2289 of 1995, to attract the private sector, the following key issues were addressed which affected seriously the economics of the lease and production sharing contracts and, consequently, the ability of project financing:

(1) Protection of the rights of the contractors from seizure. The extracted hydrocarbons could be subject to seizure, except those belonging to the Greek state;

(2) The right of the Greek state to participate in a joint venture with the contractor, both in the exploration phase, as well as in the phase of exploitation of a deposit which will be discovered;

(3) The mechanism for setting the royalty due on a case-to-case basis had to be escalated by taking into account, either cumulatively or disjunctively, the level of the production, geographic, geological, and other characteristics of the area and the coefficient between revenue and expenses;

(4) Royalties are due to the Greek state under any circumstances, irrespective of the realization or not of profits by the contractor and have to be agreed to be either in kind or in money. In the first case, royalties are determined as a per centage of the quantity of hydrocarbons that will be produced and, in the second case, as a per centage of their value, as it will be provided under the contract;

(5) Restrictions in the change of ownership of the contractor without the prior approval of the Greek state;

(6) Conditions for extending the lease contracts;

(7) Rights of the contractor to abandon the site or to terminate the exploration phase;

(8) Expropriation of land and ease rights permits and consents by local authorities for the establishment of the offshore and on-shore facilities;

(9) Temporarily use of certain sites adjacent to the area of concern to enable the implementation of the project;

(10) Expatriation of personnel or labor issues;

(11) Tax exemptions and clarification of taxation maters affecting the contractor; and

(12) Environmental issues.

## 5. Olympic Projects — Athens 2004

The selection of Athens as the host city for the Olympic Games in 2004 is an excellent opportunity for highlighting the issues that need to be resolved at an early stage by the Organizing Committee Athens 2004 S.A. (Athens 2004), if private financing were to be sought to finance the Olympic projects.

The issues contained in this section are intended to be generic and reflect those issues that have arisen on other project finance transactions within Greece and will have to be addressed and resolved.

### *a. Duration and Validity of Concession — Authorization for Entering into a Concession Agreement (Greek state as a Contracting Party)*

This has been a critical area of negotiation on other projects. The concessionaires must not only know the exact duration of the concession agreement, as well as the terms for its extension, but must be afforded a very conformable duration to make the project financially attractive. Normally, this matter is addressed either in the specific law regulating the terms and conditions of a concession or in the absence of said law, in the concession agreement which is ratified by law. In the latter case, the validity of the concession agreement is dependant on such ratification within a pre-determined period of time (usually between 90 and 120 days) without any changes.

In some instances and to preserve the sovereignty of the Greek Parliament, we have provided in the agreement that, in case of modifications by the legislative body (Parliament), the concessionaire may either accept them in writing within, e.g., 30 days of ratification, or reject them, in which case the concession agreement shall not be binding on the concessionaire. The date of ratification is usually the effective date of the concession agreement.

As regards to the validity of the concession agreement, and more particularly the power of Athens 2004 to grant concessions, this is a matter of quite critical importance. Generally, where a government (as opposed to a corporation, as in this case) is the contracting party to a concession agreement, concessionaires and their lenders can reasonably assume not only that the government is unlikely to become bankrupt, but also that it has the power to grant the concession.

However, where a statutory body or a corporation grants the concession, concessionaires and their lenders will undoubtedly wish to obtain absolute assurances that it has the necessary management and financial resources to enable it to comply with its obligations under the concession agreement and the necessary power and authority to grant the concession.

In the case of Athens 2004, since the company will be dissolved a few months later after the Olympic Games, the problem of attaining absolute assurances for financial resources could be solved by ensuring that Athens 2004 has an adequate

capital structure, or (possibly) by government guarantees but, again, the concessionaires and their lenders will still be concerned. Under similar conditions, the concessionaires requested to have a direct agreement with the Greek state instead of with the legal entity, which usually was a state-owned company to which specific rights were vested. The reason for that is the guarantee/security granted by the Greek state to the investor with respect to the terms and conditions of the concession agreement and the fact that none of them could be amended without the prior explicit approval of the investor.

### *b. Location — Size of Land*

Depending on the nature of each of the projects, issues relating to location and size of land that will be used were dealt either by applying the basic legislation or by introducing specific legislation. Each project has its own peculiarities in this respect, making it usually not comparable with other projects. Certainly in the case of the Olympic Games projects, this issue is very important and relates to the viability of each project.

It has been apparent from a number of cases that the surface of the land, which has been dedicated to host the project, irrespective of whether or not expropriation was required, was considered by the investor as insufficient for the financing of the project. As an example, in the case of the new Athens International Airport, a so-called "buffer zone" was defined (not expropriated) and has been dedicated to a possible future expansion of the airport, under specific terms and conditions as provided in the relevant agreement, e.g., restrictions were imposed on the usage of the "buffer zone". In such area it is prohibited to build anything, whereas the usage of the land is restricted only to agricultural activities.

Both of these issues will of course be critically important to concessionaires and their lenders. As indicated, the land expropriated may must include not only the land on which the project will be constructed, but also land necessary in case additional supporting activities will be required.

### *c. State or European Union Grants*

Certain projects are of marginal financial interest. Hence, obtaining of grants and subsidies in general, either directly from European Union (EU) sources or through the Greek state, is a very important element of such projects for the attraction of concessionaires. The Greek state subsidies are presently available and regulated by Investment Law 2601/1998 (*Official Gazette* 81/A/1998), which amended the earlier Investment Law 1892/1990. According to the provision of the law, the country is divided into specific areas to which different levels of grants are applicable to encourage investments thereat.

Presently, the Olympic Projects do not fall under any of the categories of investment that can be subsidized nor are to be established in an area that has any

privileges pursuant to the above legislation. Therefore, our recommendation was that a new category for Olympic Projects be included in the law or in a subsequent bill to serve the above purposes.

*d. Land Expropriation/Permitted Usages of Land*

To accommodate the particular requirements of each project, various legislative solutions have been implemented concerning expropriation of land. In some instances, the investor had the right to designate the area to be expropriated and was burdened with the relevant costs. The expropriation, however, was carried out in the name of the Greek state, e.g., the hydrocarbon concessions.

In other cases, the land was expropriated by the Greek state at cost value and was contributed to the project, e.g., the new Athens International Airport. In all cases, however, the fundamental principle was that the expropriation of land related to public benefit/usage, according to article 17.2 of the Constitution. More particularly, the Constitution provides that "no one shall be deprived of his property except for the public benefit which must be duly proven, when and as specified by law and always following full compensation corresponding to the value of the expropriated property at the time of the court hearing on the provisional determination of compensation".

The legislation governing the procedure for the expropriation of land (L.D. 797/1971) has been amended on many occasions in relation to specific projects. The amendments basically provided a framework that was more flexible time-wise. Furthermore, legislative measures were adopted to allow the concessionaires to temporarily use certain sites adjacent to the area of concern to enable the implementation of the project, e.g., in the case of the Athens Metro it was permitted to use parks, squares, or streets, as well as to create tunnels at the required depth without any compensation provided that the usual use of the properties above was not obstructed. This has been addressed sufficiently in the law.

With respect to usages of the land on which the project was implemented, the investor was consulted in most cases in advance of regulating the same by legislative enactment to secure the viability of the project. In the case of the Olympic projects, the possible post-Olympic usages of land is a very crucial matter, which is also related to the legality of the expropriation for the reasons discussed above.

Issues relating to land are perhaps the most common source of problems for concessionaires and for their lenders. The following is a list of issues which typically arise and which must be addressed at an early stage:

(1) Very often concessionaires and their lenders require some kind of assurance that the government will not expropriate the land from them; paradoxically, this is particularly so if the expropriation procedure is simple.

(2) In any project financing, the terms on which the land is held are critical and even more so in the case of projects (such as this) where the tenure of the land itself is central to the generation of revenues. Lenders will have to be satisfied on a range of issues, for instance, what is the nature of the security interest that they can obtain in the land? How easily can they enforce their security over the land and how long does that enforcement take? What taxes or stamp duty is payable on taking security over land?

(3) Where it is necessary to show a public benefit to expropriate land, and to what extent will the use of the land after the period of the Olympic Games satisfy that public benefit requirement? Must there be a continuing benefit to the public during the life of the concession?

### e. *Environmental Matters*

Law 1650/1986 on the "Protection of the Environment" has adopted EU Directives on similar issues. Obtaining an approval of an Environmental Impact Study (EIS) has proved to be a time-consuming and delayed process, as any subsequent change of the usages of land or of the surface area designated for expropriation effects the completeness of the EIS and results in delay of the works. For this reason, in certain instances, the EIS was part of the legislative enactment, in the sense that specific provisions were included in the ratifying law that regulated the issue in question.

Athens 2004 must be as certain as it can that there are no environmental matters which will prevent the land from being used for the purpose for which it is required or that involve the concessionaire or the lending banks in clean-up costs or other liabilities.

It is certain that lending banks will wish to conduct their own environmental audits of the land in question, and this will be at a stage late in the financing when there is likely to be insufficient time to rectify any problems identified or to find an alternative concessionaire and/or lenders. For this reason, as mentioned above, identification of the issues at an early stage is of great importance.

### f. *Administrative Approvals*

Investors have been concerned about the bureaucratic delays related to the issuance of the necessary licenses. For this reason, specific provisions have been included in the concession agreements aiming at concentrating/centralizing the authority for granting the licenses, as well as setting forth specific rules that will govern the licensing of the project. In some cases, the agreement itself was the primary license for the project.

The elimination, so far as possible, of bureaucratic delays is essential; typically, these can be a huge source of frustration to concessionaires, and are sometimes

easily avoided. If legislation must be passed in any event, it is possible to include a fast-track licensing procedure as part of that legislation. This has been recommended but was not included in the law.

Depending on the extent and importance of the licenses concerned, it should be verified, at an early stage, whether it is possible to grant security interests over those licenses to the concessionaires' lending banks or, if not, whether the licensors are prepared to give some other form of comfort to the lenders (for instance noting their interest in the licenses and agreeing to consult the lenders before modifying the licenses).

### g. Archaeological Findings

Archaeological findings are always a serious concern and in some instances delay the progress of the works since the Archaeological Service has the right to take possession of the site and protect the findings. The interests of the concessionaires and of the Greek state are of course diametrically opposed; in normal circumstances, the concessionaire will wish to dispose of (and, if possible, conceal) the remains of the findings as quickly as possible, whereas the Greek state will be likely to wish to preserve such remains if they are of historic interest.

By legislative intervention, the Archaeological Service was obliged to proceed with all necessary acts to protect/remove the findings within a very short period of time (a solution which did not prove to be very successful), whereas in other cases the investor was entrusted with the protection/removal at his cost, under the supervision of the Archaeological Service. The latter solution requires legislative enactment.

### h. Taxation

Certain projects require specific tax regulations, and this problem has also been resolved by legislative enactment. In some cases it related to tax-free import of goods, in other cases to freezing of tax rates at certain levels for a pre-determined period of time.

In addition, some projects were afforded accelerating depreciation rights, whereas the Greek state rarely undertook to compensate the investor for the un-depreciated value of the investment at the end of its life span. Naturally, all these arrangements require the introduction of specific legislation, but only at a later stage.

### i. Corporate Structure

In some projects, it was required to regulate the corporate structure of the investor by deviation from the regulations generally applicable.

If the articles of association included provisions that were not legally binding and not ratified by law, then such provisions were in conflict with the existing legislation on corporations.

*j. Liquidated Damages for Late Completion*

Host governments will typically require the concession company to pay liquidated damages (or some similar remedy) if it fails to complete on time. However, it would be usual for some exceptions to the completion obligation to be negotiated — usually in the nature of *force majeure* events.

The host government will obviously want to keep this list of exceptions as narrow as possible, while both the concession company and its lenders will seek a longer list — particularly in the area of *force majeure* events which, arguably, are within the overall control of the public sector (whether or not the particular department of government directly involved with the concession). The negotiation may be complicated by both the host government and lenders having some common interests in trying to keep the concession company to its agreed timetable if the *force majeure* is really within the concession company's (and its shareholders') control.

*k. Force Majeure*

Apart from its impact on completion, *force majeure* would also be a highly relevant concept insofar as it might excuse either the government or concession company from performance of its obligations or ultimately give rise to a right of termination. Both concession company and lenders might argue that the usual "government's action" categories of *force majeure* should not apply in the government's own favor.

Not unnaturally, host governments tend to resist this. The concession company's interest will be slightly different from the lenders; it will tend to seek wide exceptions through its obligations while at the same time limiting the government's right to terminate. Lenders' interests will be governed chiefly by what the consequences of termination may be.

*l. Political Risk*

Political risk can arise as an issue in a number of different contexts in the documentation. As regards the concession agreement itself, it is not usually a major issue in the classic sense in that the basic decision as to whether or not a particular government is an acceptable credit is in many ways a decision outside the scope of the concession agreement negotiation. However, there may be provisions in the concession agreement concerned with *force majeure* and particularly the risk of riots or protests which have strong political overtones.

Furthermore, it will need to be considered which party will bear the cost of complying with any new legislation. In Greece, the government has previously

taken the position that costs resultant from changes in law (including any changes resulting from EU integration) should be borne by the concession company. As with many other risk areas, the acceptability of provisions of this kind will depend to a large extent on the availability of commercial insurance.

#### m. Termination Provisions

Concession agreements may be terminated (usually) by the "innocent" party if the other party is in serious breach and in some case if *force majeure* events continue over a long period. Host governments also sometimes reserve the right to terminate on a completely "optional" basis but subject to paying off the investors, including lenders.

Equity investors will obviously wish to negotiate the maximum position on termination as regards paying off not only their equity investment but, if possible, a sum which would reflect their loss of future profits. The position can be extremely complex even where the concession company is itself in breach. Depending on the size of the termination payment, it can be argued that termination of the concession might give the government an unfair advantage in the form of a free road or bridge, unless the termination payment or other arrangements adequately protect both equity and debt investor. Obviously, there are arguments to the contrary as far as equity investors are concerned although the position of lenders is perhaps stronger.

Whether or not a termination payment can be negotiated will depend to some extent on whether the government is prepared to accept that lenders can put in place a substitute entity to operate the facility for the remainder of the concession and thus discharge the debt from future revenue.

With most projects this should not be a problem although much will depend on whether, in the particular market, there is a reasonable likelihood that substitute operators can be found. The provision on substitution and associated "step-in" rights in United Kingdom DBFO projects and other transportation projects in various parts of the world are becoming increasingly sophisticated and complex. Host governments obviously need to take care in this area since, if they are not prepared to allow substitution, there is a risk that the effect of the termination payments give lenders something close to a sovereign guarantee of their debt if one of the triggers for the termination procedure is, as is often the case, an event of default under the credit facilities.

## D. PROCUREMENT OF THE CONCESSION PROJECTS

### 1. Public Procurement Legislation

#### a. European Union Directive 93/37

Any concession project will be subject to the rules laid down by the EU on the procurement by the public sector of works, services, and supplies. These rules are

embodied in Council Directives. On a case-to-case basis, the nature of a project must be reviewed to be characterized as either a public works contract or a public works concession. We consider this distinction below.

In either case, they will be regulated by European Council Directive 93/37/EEC. The European Council Directive 93/37/EEC has been fully implemented in Greek law by Presidential Decree 23 of February 5, 1993 (*Official Gazette* A'8).

*b. Public Works Concession or Public Works Contract?*

An awarding authority must give early consideration as to whether the project should be classified as a "public works concession" or a "public works contract".

The Directive contains special provisions for the procurement by public works concession. These provisions are less burdensome to the awarding authority than those that apply to procurement by public works contract. Ideally, provided the characteristics of each project satisfy the criteria in the Directive for a public works concession, this classification would be adopted.

The Directive defines a public works concession as a contract of the same type, i.e., a public works contract, except for the fact that " the consideration for the work to be carried out consists either solely in the right to exploit the construction or in this right together with payment".

In Greece, projects which have been successfully classified as public works concessions have included the Rion–Antirion Bridge across the Gulf of Corinth, Athens New International Airport Spata, Canal of Corinth, Ring Road Stavros-Elefsina-Spata, various motorways, and the contract to construct the Malliako tunnel. Due to the opportunity afforded to the concessionaire in these cases to levy tolls and charges on third party users of the built asset, they have been able to satisfy the criteria for a public works concession.

Whether or not a project can be classified as a public works concession will similarly depend in each case on its uses and whether those uses can be said to include a right for the concessionaire to exploit the works, e.g., to charge usage fees, as part of its revenue stream. If the project revenue streams are mainly available as type payments and no significant alternative "exploitation" or third party revenues can be developed, it is likely to be very difficult to justify classifying the projects as public works concessions.

The advantage of a public works concession over a public works contract is that it is subject only to the requirement for publication of a notice or advertisement in the *Official Journal*. The advertisement must allow not less than 52 days for receipt of bids, as opposed to not less than 37 days in the case of the negotiated procedure. The Directive imposes no further procedural requirement, e.g., to pre-qualify bidders or to follow stipulated bidding procedures and award criteria, both of which apply to public works contracts.

### c. Negotiated Procedure

If a project and its post-Olympic uses are classified as public works contracts, this will involve a procurement procedure with a number of stages, commencing with the publication in the *Official Journal* of the Prior Information Notice, followed by the more detailed Contract Notice, pre-qualification of interested bidders, short-listing, and invitation to tender or negotiate.

Although classification as a public works contract lacks the flexibility of the public works concession procurement route, it does provide clarity and certainty for all those involved in the bidding process. An awarding authority would be bound to follow one of the stipulated bidding procedures, the "open procedure", "restricted procedure", or "negotiated procedure". The negotiated procedure would allow the flexibility to negotiate acceptable and bankable contract terms and would allow maximum scope for innovation by bidders.

It is also the procedure used in many project finance transactions. Under certain conditions, the open and restricted procedures would be appropriate. For example, the open procedure does not permit the contracting authority to limit tenderers to those who are suitably qualified and experienced. The restricted procedure precludes negotiation. This in turn greatly limits the scope for private sector innovation and public or private sector dialogue in project development.

### d. Official Journal Notice

It is clear that whichever of the award procedures is to be followed the starting point for the procurement process will be publication of a Notice in the *Official Journal* calling for candidates to apply to participate as bidders, followed, in the case of a public works contract, by a further, more detailed notice.

The Directive specifies in detail the forms that such notices should take. Great care will need to be taken in drafting the notices. An incomplete notice, or one which inadequately describes the project or such matters as the location of the site, the nature and extent of the services, information regarding minimum economic and technical standards to be achieved by bidders, or requirements regarding variant bids, may expose the project to challenge on the basis that it has not been properly advertised. There is a risk, where a project is not correctly advertised and subsequent procedures are not properly followed, that the bidding process may must be recommenced with publication of a new notice in the *Official Journal*.

### 2. Procurement Process

The key objective of the procurement process for any project is to:

(1) Maximize the amount of private sector financing raised;

(2) Minimize the amount of government support required; and

(3) Select a private sector concessionaire that will design, deliver, finance, and operate the project on terms that are likely to offer the best value for money.

The most suitable concessionaire will be one that is technically and commercially capable, financially robust, and enthusiastic to obtain and enter into the concession on the best terms.

A typical procurement process is as follows:

(1) Stage 1: Finalize Procurement Strategy and Further Market Sounding;

(2) Stage 2: Identify Specifications;

(3) Stage 3: Pre-qualification;

(4) Stage 4: Invitation to Tender (ITT); and

(5) Stage 5: Selection of Preferred Bidder.

## E. MANAGING THE PROCESS

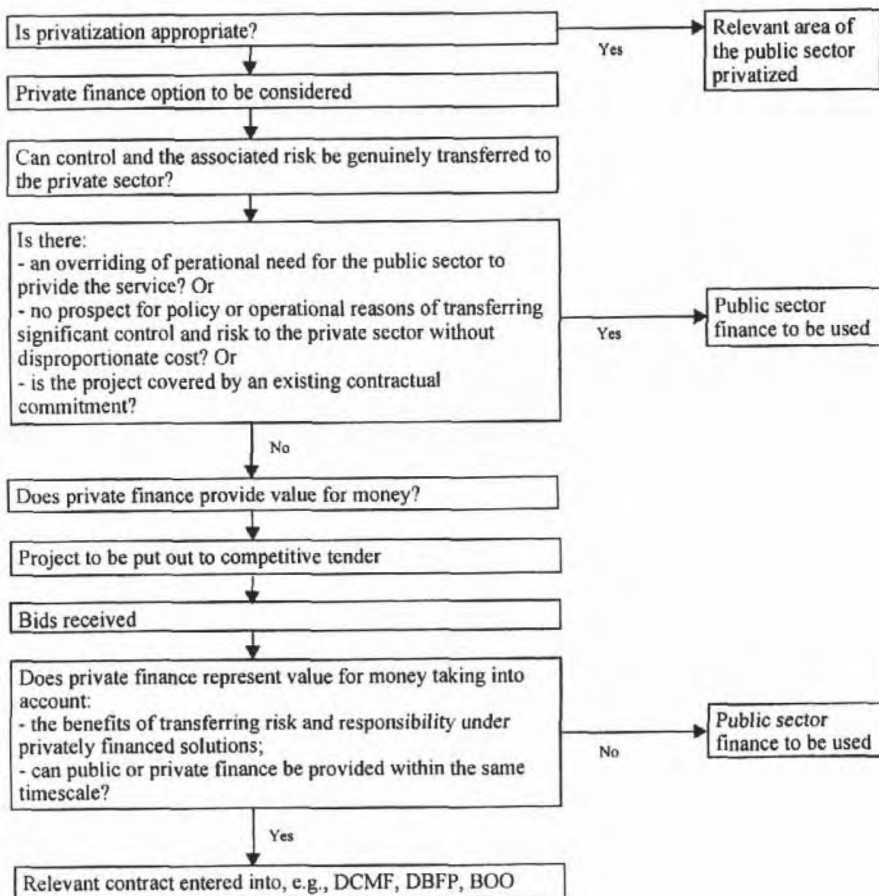
The Greek state must take the following steps in preparing the process for privatization:

(1) Set policy objectives in privatizing the project, addressing political issues in advance;

(2) Develop the project as an attractive investment prospect in terms of capital outlay, projected returns, and overall risk levels; and

(3) Identify the need of any additional legislation that might be required to allow the privatization, i.e., proposing required legislation (Laws, Presidential Decrees, or Ministerial Decisions) which will comprise the regulatory, contractual, and legislative framework under which the tenders for the concession contracts will be carried out.

## F. APPLICATION OF GUIDELINES



# CHAPTER 9
# THE NEW ITALIAN LAW ON PROJECT FINANCE

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## A. PROJECT FINANCE IN ITALY — OPPORTUNITIES AND LIMITS

### 1. The Italian Situation

The need for infrastructure investment in Italy is extremely high and increasing in several areas, e.g., telecommunications, transportation, water and wastewater treatment, electricity generation, and solid waste disposal. Infrastructure investments are of crucial importance for Italy both from an internal point of view and from an international perspective. In fact, on one side, these types of investments are needed to reduce the disproportional level of infrastructure existing between the north and the south of Italy. On the other side, infrastructure investments are essential to enable Italy to keep up with the other European Union (EU) Member States.

Until recently, infrastructure investments in Italy (as in most EU countries) were mainly financed by the government. The major problems related to this type of investment have been represented by the limited resources available to finance public projects and the inadequacy of the administrative agencies in the development and management of public projects due to the lack of technical skills and management capability.

It shall also be taken into account that the Italian government (like other EU governments) has the need to reduce the national deficit and the government debt to a limited percentage of the GDP (no more than three per cent) to comply with the requirements set forth by the Treaty of Maastricht.

Therefore, project finance, which is a form of financing aimed at facilitating the use of private capitals to finance projects of public interest, is likely to play a significant role to overcome the aforesaid problems related to infrastructure investments.

In light of the above, Italy has adopted legislation allowing the use of private capital to finance public projects in various areas of substantial infrastructure investments, which consequently have become considerably profitable for private investors.

The Ronchi Decree issued on February 1997 has regulated the disposal of solid waste, implementing the EU Directives on waste, packaging waste, and hazardous waste. As a result of the legislation, various waste-to-energy projects have been financed using project finance techniques. Similarly, the Consolidated Text, which regulates water and implemented European Community (EC) Directives number 91/271 and 91/676, has been adopted in April 1999, with a positive effect on the increase of infrastructure investment in the water treatment sector.

It must be noted that the latest Financial Law (*Legge Finanziaria*) includes a section pre-determining a series of projects of public interest to be financed by means of the project finance, such as the construction of new highways in the Piedmont and in the Salerno-Reggio Calabria areas as well as the building of the bridge over the Messina strait.

## 2. How Project Finance Has Been Used in Italy

Project finance has been widely used — prior to the enactment of the Merloni Ter Law — mainly in the electricity generation field to finance the construction of electric power plants. This was also due to the fact that, until recent times, the electric energy system was managed in a monopoly by a state-owned company, ENEL, subsequently privatized, and the relevant legislation provided the obligation of such company to withdraw all types of electric energy produced by private parties.

In other relevant infrastructure investment areas, the use of project financing was *de facto* limited by several elements. The first limiting factor is represented by the discretion of the public administration in granting of the concession and in determining certain mandatory parameters related to the concession. In fact, the granting of a concession is governed by administrative law provisions which, in most cases, cannot be deviated from by the parties.

Moreover, a basic principle of administrative law is the discretion of the public administration in the performance of its activity and in pursuing its objectives. Therefore, in some cases, it may be difficult to enforce certain security and payment provisions against administrative authorities.

In addition, it is generally difficult to obtain real guarantees in the public sector. In fact, under Italian law, certain property can be owned only by the state, such as coastal areas), and certain categories of such state owned property cannot be disposed of by the state.

Another difficulty is represented by the uncertainty on the revenues to be generated by the project once operational; this is due to the discretion of administrative agencies which are entitled to determine and/or modify the tariffs to be applied for the services provided by the holder of the concession running the project.

Following the enactment of the Merloni Ter Law, which addresses some of the issues mentioned above, project financing is expected to further develop in other areas of public interest, e.g., telecommunications, waste to energy, water treatment, and transportation.

## B. ITALIAN LEGISLATION REGULATING PROJECT FINANCE

### 1. Relevant Legislation

Article II of Law Number 415/1998 (the Merloni Ter Law) regulates, for the first time, certain aspects of project finance transactions. It amended Law Number 109/1994, which governs the concession of construction and the management of public works.

Article 7 of Law Number 144/1999 creates the Technical Unit for Project Finance, a special governmental agency in charge of the promotion of project finance.

Presidential Decree Number 34/2000 is the regulation governing the qualification system for the participation in public bids, and it governs all aspects relating to the qualifications and requirements to be fulfilled by public works' constructors.

### 2. Law Number 415/1998 (Merloni Ter Law) and its Context

Law Number 415/1998, which governs the concessions of public projects, has regulated for the first time certain aspects of project finance transactions by amending Law Number 109/1994, governing, *inter alia*, the concessions of construction and management of public works.

The Merloni Ter Law does not provide a definition of project finance. In the Italian market practice, project finance has been considered basically as a complex transaction aimed at financing specific infrastructure projects of broadly public interest, likely to generate, once operative, a cash flow to remunerate the invested capital. Project finance is applicable to public works as well as to private projects of public interest, e.g., electricity plants, oil plants, and waste to energy.

The purpose of project finance consists in the carrying out of a project of public interest and the management of the public work in connection thereto; project finance overcomes problems related to the limited funds available in Italy to finance public projects.

The essential structure of project finance transactions pursuant to the Merloni Ter Law is based on the establishment of a special purpose vehicle for the carrying out and the operation of the project and the participation of several subjects having different interests and roles in the project, e.g., promoters, financing parties, or guarantors.

From a legal point of view, a project finance transaction is the sum of several agreements, concerning the supply of know-how, materials, granting of loans,

guarantees, establishment of special-purpose vehicles, contracts concerning the concession, and the operation of public works. The parties to a project finance transaction are:

(1) The administrative agency (the public body interested in the performance and operation of the project for reasons of public interest);

(2) The special purpose vehicle (the project company);

(3) The promoters (subjects providing the relevant know-how and risk capital in participating in the special-purpose vehicle); and

(4) Finance parties and guarantors (banks and insurance companies).

### 3. The Promoters

Article 37 *bis* of Law Number 109/1994 (introduced by article 11 of the Merloni Ter Law) provides that only promoters are entitled to submit project proposals to the administrative agencies.

The categories of promoters provided by the Merloni Ter Law and the Presidential Decree Number 34/2000 are the following:

(1) Subjects (individual entrepreneurs, companies, or associations of co-operative companies) entitled to take part in bids for public works under article 10 of Law Number 109/1994;

(2) Engineering companies, as defined by article 17, paragraph 1(f) of Law Number109/1994;

(3) Subjects which professionally carry out financial business, insurance business, technical-operative activities, or consulting activities in the public works sector, provided that the subjects or entities have taken part, to a significant extent, in the performance of projects of a value in the amount at least equal to the one concerned by the proposal; and

(4) Special-purpose entities, provided that their majority capital is held by subjects complying with either of the qualifications specified above.

In practice, the Merloni Ter Law favors those subjects which may qualify as "constructors" according to the criteria set forth in the previous legislation.

However, as far as the verification of the qualifications is concerned, Presidential Decree Number 34/2000 (Regulation on the qualification system for the participation in public bids) has abolished the National Register of Constructors (*Albo Nazionale Costruttori*). Therefore, constructors cannot rely anymore on the certification system based on the registration with the Register to provide evidence of their qualifications.

Presidential Decree Number 34/2000 has set forth a more effective verification system, requiring that public works contractors be submitted to a "quality certification" to be carried out by private companies in charge of the verification process.

### 4. The Project Proposal

Promoters shall be entitled, by June 30 of each year, to submit to the responsible administrative agencies project proposals falling into the category of either public works or works of public interest specifically described in the three-year planning document prepared by the administrative agency. The project proposal shall contain:

(1) A frame environmental analysis;

(2) A feasibility study;

(3) A preliminary project;

(4) A framework agreement draft;

(5) An economic-financial plan insured by a bank;

(6) The specifications of the services to be provided by the project;

(7) The guarantees offered to the administrative agency; and

(8) The costs incurred by the proposed project.

### 5. Evaluation of the Proposal

By October 31 of each year, the administrative agency shall make a feasibility assessment of the proposal submitted on the basis of environmental, impact, functionality, quality, expected costs, and revenues of the project, as well as on the basis of the term of the concession, the terms of the contracted works, and the tariffs to apply and the financial value of the plan. The evaluation shall compare all proposals received even if relating to different projects.

At the end of the evaluation process, the relevant administrative agencies will select those proposals deemed of public interest which shall be concerned by the concession procedure.

### 6. The Concession Procedure

The concession procedure consists of two stages, i.e., a bid procedure and a private negotiation procedure.

The bid procedure shall be initiated by the administrative agency by December 31 of each year for each of the selected projects of public interest, and shall be carried out in accordance with the criterion of the most economically favorable offer. This

stage is aimed at determining whether there are other subjects interested in the building and operation of the work under the conditions set forth by the promoter.

The private negotiation shall subsequently take place among the two best bidders and the promoter to award the governmental concession for the building and the operation of the project. This stage is aimed at selecting the most appropriate subject for the construction and operation of the work under the most convenient conditions for the administration.

## 7. The Special Purpose Vehicle (Project Company)

Pursuant to article 37 *quinquies*, introduced by the Merloni Ter Law, the holder of the winning bid is entitled (has the faculty) to incorporate a limited liability company which will automatically become the holder of the concession to build and operate the project.

The special purpose vehicle shall be incorporated in the form of a joint stock company (SpA), a limited liability company (Srl), or an association of companies. The public bid may determine the minimum capital requirement.

The establishment of the special purpose vehicle determines the segregation of the assets (and of the revenues) relating to the project from those personal to the shareholders. In fact, the special purpose vehicle is an independent entity aimed at collecting revenues and minimizing the risks deriving from the project.

The special purpose vehicle will also be entitled to issue bonds (nominative or to the bearer) beyond the limits set forth by section 2410 of the Civil Code, i.e., more than one time the capital. The bonds shall be secured pro-quota by a real estate mortgage.

## 8. Termination of the Concession

Article 37 *septies* provides indemnification and compensation for the holder of the concession in the event the concession is terminated either for breach of the administrative agency or is withdrawn for reasons of public interest.

The indemnification and compensation will include:

(1) The value of work performed and accessory costs net of depreciation (if performance has been completed and accepted);

(2) The cost actually borne (if performance has not yet been accepted);

(3) The penalties and other costs connected as a result of termination; and

(4) Indemnification in the amount of 10 per cent of the work to be completed as compensation for loss of profit.

## 9. Guarantees for the Financing Parties

The Merloni Ter Law contains several provisions aimed at guaranteeing the parties financing the projects.

Article 37 *septies*, paragraph 2, provides the destination of any indemnification and compensation paid by the administrative agency to the holder of the concession to satisfy on a priority basis outstanding credits granted by the financing parties. In practice, all sums reimbursed to the holder of the concession pursuant to paragraph 1 of article 37 *septies* (in the event of termination for breach of the administrative agency) shall be used on a priority basis to satisfy outstanding credits of the financing parties.

The compatibility of that provision with the Italian Constitution is currently debated as the said special rule apparently prevails on general provisions concerning the liens of labor credits and tax credits, which are mandatory provisions of an imperative nature.

Article 37 *octies* provides as an additional guarantee for financiers the faculty of substitution of the present holder of the concession with a new concessionee in the event of termination of the concession caused by the holder of the concession.

Pursuant to the said provisions, in the above-mentioned case, the promoters will be entitled to designate within 90 days from the notice of termination, a new concessionee. However, the effectiveness of this provision depends on the date of the enactment of a Decree of the Ministry for Public Works, which is expected in due course.

Article 37 *nonies* also provides a general lien on personal movable properties of the holder of the concession in favor of financiers pursuant to sections 2745 *et seq* of the Civil Code.

The lien shall be formalized in writing and shall identify all original financiers as well as describe the amount of the credit and aspects of the financing. It shall be enforceable against third parties provided that the relevant deed is registered pursuant to section 1524, paragraph 2, of the Civil Code.

Notice of the creation of the lien as well as of the registration of the lien is given in the *Journal of Legal Notices (foglio annunzi legali)*. Article 37 *nonies* deviates from section 2747 of the Civil Code, which provides that a general lien cannot be exercised in breach of third persons' rights on movable assets. In practice, the lien provided by article 37 *nonies* grants the financiers a sort of "mortgage over movable properties".

Furthermore, the transfer of this type of guarantee is facilitated as no other fulfillment or payments are required in addition to the above-mentioned registration.

# CHAPTER 10
# GUARANTEES IN PROJECT FINANCE IN SPAIN

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## A. CUSTOMARY FORMULA FOR PROJECT FINANCE

The most customary formula for project finance in Spain is to use a company having as its exclusive corporate purpose the development and management of the industrial project to be financed through a Special Purpose Vehicle (SPV). Through this, the following may be achieved:

(1) Limitation of the promoting partners' liability. The liability is limited to the disbursement of the capital agreed for the SPV, save for express covenant that extends that liability;

(2) Unity and separation of the economic enterprise; and

(3) Individualization of the risk, separate accounts, and its own creditors.

## B. LIST OF GUARANTEES IN PROJECT FINANCE

Guarantees in the purest sense are real estate mortgages, mortgage of a concession, mortgage of facilities, mortgage of a commercial establishment, pledge on the securities representing the SPV's capital, and pledge or assignment in guarantee of present and future credits.

Conversely, there are also covenants or undertakings, such as from the partners for predetermined technical causes, which are not strictly speaking guarantees.

## C. MORTGAGE

### 1. General Features

#### *a. Definition*

A mortgage is a security interest of an ancillary and indivisible nature, linking property and the realization of its value to secure the performance of a monetary

obligation; it is constituted by registration, which falls directly and immediately on the real property of another, available for disposal, which remains in its owner's possession.

As a security interest, it is a subjective right that attributes to its holder direct or immediate authority over the asset, no intermediary with personal obligation being required (immediacy), and it also imposes on all (*ergo omnes*) an obligation of respect or abstention (absoluteness).

The main effect of a mortgage occurs at the time it is constituted, to place the value of the asset at the disposal of the holder of the secured credit. This means that the value is linked to the certainty of collection of the credit and must remain unchanged. From this, it can be seen that the owner must refrain from performing actions that could cause the value of the mortgaged property to depreciate; if the value diminishes, the mortgage holder may require the mortgage to be increased, and, above all, in the case of default in payment, the creditor is authorized to realize the value of the mortgaged asset through its mandatory foreclosure.

This is provided for in article 1858 of the Spanish Civil Code, which states that "it is also the essence of these contracts that on maturity of the principal obligation, the assets on which the pledge or mortgage is constituted may be sold to pay the creditor".

"The mortgage may be constituted to secure all kind of obligations whether pure or subject to a condition precedent or subsequent".[1] The amount of the obligation secured or the maximum amount for which the mortgaged property is made liable must be determined. Although, strictly speaking, the consideration or obligation secured does not need to be economic, the mortgage liability must always have economic content, and its amount must be set at the time of execution.

### b. Value as an Impediment

In addition to its essential purpose of realizing value, a mortgage also produces important effect as an impediment. Since the system of registration gives priority to the right that is first registered, the constitution of a first mortgage on assets gives the mortgagee priority over any other creditor in the foreclosure of that property, even when the later debts originate from preventative annotations ordered by the judicial authority. This means that once the property has been mortgaged, it will lose interest for other creditors as the subject of their attachments.

On the other hand, it is often difficult to dispose of mortgaged assets, since bidders are unlikely to participate in an auction to continue a business requiring high technical capability, such as all cases of administrative concessions, licenses, and industrial plants.

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[1] Mortgage Act, article 105; Civil Code, article 1861.

#### c. *Practical Difficulty of Foreclosure*

The specialty of the business often means that practical difficulties arise during foreclosure. It is hard to imagine that bidders will spontaneously participate when high technical capabilities are required. Normally, disposal will not take place through the channel of mandatory foreclosure, but rather through agreed formulas in which a person is sought to take charge of the industry.

Additionally, certain recent court decisions are more concerned with the protection of consumers' rights than with the protection of the security of private trade. The Supreme Court, on March 27, 1999, denied the creditor banks the right to declare the early maturity of the debt, terminate the contract, and enforce the entire amount, despite being faced with default in payment of one year of interest and repayments.

From the foregoing, it is deduced that the mortgage fully conserves its function as a right linked with value and that it always takes precedence over any subsequent right.

### 2. Formalization

#### a. *Public Deed, Registration, and Stamp Duty*

The constitution of a mortgage requires the execution of a public deed, its registration at the respective registry, and the payment of the tax on legal documents (stamp duty), of 0.5 per cent on the total amount of the mortgage liability. The mortgage liability, including capital, interest, and costs, usually amounts to at least 160 per cent of the total amount of the credit facility or loan. Therefore, the tax on its constitution is in the region of 1 per cent of the total amount of the debt.

#### b. *Registration*

Constitution of the mortgage in due form provides the mortgagee with the advantages of associated value and priority described above.

#### c. *Alternatives*

Alternatives to mortgages include undertakings to mortgage, granting irrevocable powers of attorney, taking mortgages subject to a condition precedent, and granting preferential ranking.

The high tax costs, approaching 1 per cent of the debt, to which must be added 0.5 per cent for future cancellation, has meant that, in practice, intermediate formulas are sought, which do not reach the point of constitution but which grant the creditor banks certain advantages and "surety".

Thus, e.g., an undertaking to constitute a mortgage is frequently agreed for the event that certain hypotheses occur in the future, after the credit has been granted

and drawn, related either to the diminishment of the borrower's apparent solvency or to an evolution of the business less favorable than expected. The obligation to constitute a mortgage is agreed if the expected ratios are not reached in any fiscal year. This undertaking is accompanied by an irrevocable power of attorney conferred by the borrower on a financial institution, agent bank, or bank designated to enforce guarantees.

This system guarantees to the bank that in such hypotheses, the mortgage will be constituted without requiring further consent from the borrower, thus facilitating the practicality of this instrument. However, the mortgage will exist and will have priority only once it has been constituted. Until then, the agreement "only gives rise to personal action among the parties".[2]

Immediate payment of the tax on legal documents may also be avoided by constituting the mortgage subject to a condition precedent. In this way, the obligation to pay the tax will only arise once the condition has been met. This condition could again be the failure to reach certain ratios in a given fiscal year, and it may be considered proof with the report of the borrower's auditor. This avoids the tax payment, but leads to the problem of the preferential ranking of this mortgage, subject to a condition precedent, in comparison with rights registered after the mortgage but before the condition is met.

### 3. Real Estate Mortgage

The real estate mortgage extends to the property itself and also to other elements, by legal provision or by express agreement.

The following will be understood to be mortgaged together with the property, even if they are not mentioned in the agreement, provided that they belong to the owner:

(1) Natural accessions;

(2) Improvements consisting of new plantations or repairs, but not new constructions, which require an express covenant;

(3) Compensations granted and owed to the owner because of the mortgaged properties, provided that the event causing them takes place after the mortgage is constituted; and compensations for compulsory purchase;

(4) Permanent furnishings and fittings that cannot be separated without damaging the material or deteriorating the subject;

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[2] Civil Code, article 1862.

(5) Easements on land together with the dominant estate; and

(6) Surplus area.

An agreement must exist to include the following items in the mortgage:

(1) Furnishings;

(2) Products, whatever their situation may be;

(3) Rents due and outstanding at the time the performance of the obligation are demanded;

(4) Aggregated land, provided that it is not due to natural accession; and

(5) Buildings erected where none previously existed.

In connection with the third-party owner, i.e., the owner who is not the mortgagor, the mortgage naturally extends to the aforesaid elements, but never to elements the inclusion of which must be agreed, since that third-party owner could not have participated in such an agreement. The mortgage will not extend to furnishings and improvements paid for by the new owner or to pending products and accrued rents. In the event of foreclosure, the third-party owner may opt between demanding the amount of the objects and rights he owns or withholding them.

### 4. Chattel Mortgage

The following may be made the subject of the chattel mortgage:

(1) Commercial establishments;

(2) Cars and other motor vehicles, trams, and railway carriages;

(3) Aircraft;

(4) Industrial machinery; and

(5) Intellectual and industrial property.

The right of chattel mortgage and the assets that may be the subject of pledge without removal cannot be mortgaged.

The pledge without removal of possession is not used in project finance since it may only be constituted concerning products, agricultural harvests and livestock, working tools, machinery, and animals.

## 5. Mortgage of Commercial Establishment

### a. Definition and Requirements

This mortgage is based on the commercial establishment as the company's physical support and most permanent element having an intrinsic and objective value, in some way independent from the merchant's business and the company's other elements. This mortgage, on its basis, may be extended to other assets of the company.

The most frequent title to the commercial establishment arises from the lease. However, the owner operating his own industrial or commercial premises is permitted to take advantage of this form of security. The mortgage constituted by the owner on the establishment will be fully independent from the mortgage he may constitute on the real property he owns. Thus, it is provided that whoever acquires the mortgaged commercial establishment through enforcement will have the status of lessee of the premises on the terms previously stipulated in the public deed of constitution of the mortgage. In this way, whoever carries on industry or trade in his own premises is provided with two possibilities of guaranty: the real mortgage on the property and the chattel mortgage on the establishment.

### b. Objective Extension of the Mortgage

The mortgage covers:

(1) The right to lease the premises and its fixed and permanent installations;

(2) Intellectual and industrial property rights;

(3) The working tools and equipment of the establishment;

(4) Sometimes, goods and raw materials, under an express covenant; and

(5) The mortgage extends to compensations granted or owed to the owners of the establishment under a subrogation agreement.

## 6. Mortgage of Administrative Concession

The Mortgage Act expressly recognizes the possibility to mortgage administrative concession in its article 107.6, according to which the following may be mortgaged:

> Administrative concessions of mines, railways, canals, bridges, and other works intended for public services and privately-owned land or buildings that, although they are not directly or exclusively used for such services, are added to such works; in the first case, the mortgage is made pending the termination of the concessionaire's right.

The most important features of a possible mortgage on a concession are:

(1) Authorization from the Administration which granted it;

(2) Vicissitudes of the concession; and

(3) The procedure for its foreclosure has special features.

## D. PLEDGE OF SECURITIES

In Spanish practice, the pledge on the securities of the SPV used to implement the project is the most extended guarantee in project finance. This pledge has no important special features, and merely the following should be emphasized:

(1) It is granted by the partners or shareholders of the company and not by the company itself. For this reason, the obligations it secures and the liabilities assumed by the guarantor partners with regard to the debt should be stipulated clearly and precisely. This liability may be universal or restricted to the assets given in pledge; and

(2) At the time of enforcement, which would be carried out through a notarized (or judicial) auction, the pledge may acquire ownership provided that:

  (a) the scheduled auctions are held and declared void; and

  (b) the pledge gives a receipt for the total amount of the credit.

Other than in this case, the pledge may not appropriate or dispose of the things given in pledge.[3]

The reason why the prohibition to the pledge to appropriate the asset is prohibited is because it could lead to abuse, to the detriment of the pledgor and its other creditors. This prohibition is also considered to include elements such as the mandate to sell granted to the pledge. Numerous intermediate forms exist. The following forms have dubious validity:

(1) Transfer of the assets to the pledge and granting the pledgor the right to acquire them for the amount of the debt (*fiducia cum creditore*); and

(2) Granting to the pledge an option to purchase the asset for a price equal to the amount of the debt, which option may be exercised if the pledgor does not pay, setting off the price against the amount owed.

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[3] Civil Code, article 1859.

## E. PLEDGE OF CREDITS

The typical feature of project finance is that credits against customers for the goods, services, or supplies created and supplied by the business or industrial project are used to repay and service the debt of the project. For this reason, the fundamental subject of the guarantees granted to the financial institutions consists of the financed industrial establishment and the future credits.

In the case of the guarantee on present or future credits, questions are raised as to its legal viability, theoretical form, requirements for its effectiveness, and consequences or effects.

In principle, the two forms of guarantee on credits are the pledge and the assignment in guarantee.

The pledge on rights, initially permitted by Roman Law, is included in Spanish legislation with the provision "everything may be pledged . . . both tangible and intangible things". However, some legal authors consider the transfer of possession of the thing to be an essential feature of the pledge, and argue that the pledge on rights is not a true pledge that can be equated with the pledge of things, but rather a "conditional assignment for the purpose of guarantee". However, general legal doctrine accepts the idea of the pledge of rights provided that they are movable, transferable, and in trade.

To the extent that credit rights are not available for possession, doubts are raised as to whether they are suitable as a subject for a pledge. However, to the extent that the purpose of delivery is to impede the disposal of the thing by the pledgor, the transfer of possession of credits may be replaced by notice of the pledge given to the debtor of the credit assigned, to ensure that the debtor does not pay it.

Two cases may be differentiated in the realization of the pledge on rights:

(1) If the credit given in guarantee matures before the secured credit, the pledge is entitled to demand payment, enforcing the pledged credit and collecting it directly; the amount received by the pledge from the assigned debtor through the subrogation will replace the credit canceled by the payment; and

(2) If the secured credit matures before the credit given in guarantee, in the event of default of the debtor, the pledge may have recourse to the enforcement procedure through notarial auction or, the more practical course of action, the pledge could wait for the credit given in guarantee to mature and then demand its payment from the assigned debtor, setting the amount collected against the debt.

In summary, the use of the pledge of credits will involve:

(1) The need for it as public deed;

(2) Notice to the assigned debtor; and

(3) The preferential ranking and privilege of article 1922.2 of the Civil Code would be deemed to apply, although for this purpose an extensive interpretation of the "thing pledged" would be required.

Assignment of credits in guarantee is admitted provided that the assignment of credits in Spanish law is understood in its broad sense, i.e., conceiving assignment to be a legal transaction made by the assigning creditor with the assignee, whereby the former transfers to the latter its title to the assigned credit.

The change made in the person of the creditor does not extinguish the original obligation, but rather the link continues to be the same. The assignment may have any cause: sale, swap, donation, contribution to the company, *solvendi causa*, or *solutoria* of a different credit, or *fiduciae causa* (assignment of collection).

Through the assignment in guarantee, a special form of joint ownership of the assigned credit is created. Since Spanish law is causal law in which sufficient cause of the consideration is required, the guarantee is not considered sufficient cause for transfer or full ownership of the credit. Therefore, the assignment in guarantee creates a special form of ownership, unlike other legal systems, such as the German system, which permit abstract capital transfers.

The system for the assignment of credits has the following features:

(1) It does not take effect against third parties until its date is deemed to be certain according to articles 1218, 1227, and 1526 of the Civil Code;

(2) The debtor who pays the creditor before knowing of the assignment will be released from the obligation; and

(3) The privilege of collection and the resistance to bankruptcy would find their justification in the joint ownership created or the assignment performed, and the credit would be excluded from the bankrupt's estate.

The assignment of credits resolves the problems of execution, particularly the fact that the notices which would make the guarantee impossible are not required, e.g., there are no notices of credits against the users of public services, water and electricity rates, or motorway tolls. Notice to the assigned debtor is not a requirement for the existence of the assignment, but merely affects the debtor's good faith.

The most debatable question of the assignment of credits refers to future credits, particularly after the change of the law on risk capital, (*Official State Gazette* of January 6, 1999). This law has regulated the system governing certain credit

assignments, laying down certain rules that, if they were generally applicable, would completely prevent project finance in Spain.

The essential consequences of this law are resistance to bankruptcy and the non-requirement of a public deed. If these consequences can only be said of the credits to which the law refers and are not the consequence of the Spanish legal system, then assignment would be impossible, whether of future credits or of credits against the Administration. However, in our opinion, this law has specific scope and refers only to given factoring contracts, a sector it is proposed to promote, and consequences of general application cannot be obtained from it.

# CHAPTER 11
# BUILD, OPERATE, TRANSFER PROJECT FINANCING IN EMERGING COUNTRIES

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## A. INTRODUCTION

### 1. Scope

The objective of this paper is to define and describe a framework for the rules under international law that are generally applicable to project financed industrial infrastructure projects in emerging countries. Project financing is a technique designed to make external funds from the private sector available for public infrastructure investment projects.[1]

Project financing is required by emerging countries which, in spite of expanding public infrastructure requirements, can not raise the necessary financial means from domestic sources, whether by borrowing, fiscal measures, or on the international capital market. The group of emerging countries which fall into this category are China, Southeast Asia, and African and Latin American countries.

The issues of this chapter are approached from the perspective of the government of the country where the project will be implemented. The best interests of the government will be emphasized, and a fair and realistic balance between the rewards and risks of investors and entrepreneurs will also be surveyed. The legal situation of the Chinese People's Republic, Hong Kong in relation to project finance is also covered.

The chapter will survey the basic structure of interconnected agreements and contracts required for project financing and the methodology for choosing the foreign direct investors and negotiating the basic agreements and contracts. In addition to the economic and technical advantages that competitive bidding entails in

[1] The author wishes to acknowledge the inspiration he received from technical assistance experts and former colleagues in the United Nations Industrial Development Organization. He would also like to acknowledge the assistance on understanding the laws of China from attorney Anthony W.Y. Chan, partner, Koo and Partners, Hong Kong.

comparison with a series of direct negotiations, the important objective of transparency is more easily attained, which, in turn, is an effective disincentive to corruption of the involved decision-making public officials. The concept of international competitive bidding has been recognized as a requirement in the legislation of important emerging countries, such as China, The Philippines, Thailand, and Vietnam. Among the 70 legislative recommendations contained in the draft chapters of a "Legislative Guide on Privately Financed Infrastructure Projects", prepared by the Secretariat of the United Nations Commission on International Trade Law (UNCITRAL), the following is relevant in this connection:[2]

> Recommendation 14. The Law should provide for the selection of the concessionaire through transparent and efficient competitive procedures adapted to the particular needs of privately financed infrastructure projects.

Accordingly, this chapter focuses on applicable international rules that governments and public authorities in emerging countries should observe when inviting tenders for such projects and when evaluating the bids, negotiating with the preferred bidder, and awarding the project. Since it is essential to attract foreign investors and to persuade them to offer the most favorable terms possible, they in turn must be assured that the competitive bidding, including evaluation, negotiation, and award, will be conducted in a fair and transparent manner.

Considering that, in emerging countries, national legislation is often considered neither to be adequately developed, and formulated, nor to possess sufficient credibility to provide necessary guarantees of fairness, predictability, and transparency that a serious foreign investor will expect to submit a bid, or not to demand an excessively high profit margin, it is advisable instead to have recourse to generally accepted rules of international law when preparing the procedure and the solicitation documents for the international competitive bidding.

Depending on the legal requirements in the country concerned, initiation of Build Operate Transfer (BOT) projects may require the enactment of legislation or a special decree to clearly provide an adequate legal framework. Such steps have been taken in a number of emerging countries, for instance, with the objective of setting up a "one stop" authority to assist interested parties in the processing of administrative and legal matters, but typically without complete authority to autonomously decide all questions, in particular those involved in the imposition of sanctions for breach of the established procedures or agreed conditions.

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[2] Official Records of the United Nations Commission on International Trade Law, A/CN.9/471/Add.9, December 2, 1999.

## B. BUILD, OPERATE, TRANSFER (BOT)

### 1. Project Agreement

Build, Operate, Transfer (BOT) projects are infrastructure projects that are implemented by a private sector consortium pursuant to a concession (Project Agreement) granted by the government. The consortium is formed through an agreement between the shareholders who may comprise the suppliers of equipment and technology, engineering and civil construction companies, and banks or investors, who establish a local company (Project Company) to undertake the planning, financing, and construction of the infrastructure facility.

On completion of construction, the Project Company will operate the facility for the duration of the concession and, during this period, which typically may vary between 20 and 30 years, the Project Company will receive revenues from the users or beneficiaries of the constructed facility or those who will purchase its production. If the Consortium owns the facility during the period of the concession and thereafter transfers legal title — and usually custody and operating responsibilities — to the government, the project is referred to as Build, Own, Operate, Transfer (BOOT). Typically, the transfer is without compensation.

The BOT concept is suitable for major infrastructure projects, such as power stations, toll bridges or roads, water works, airports, harbors, and telecommunication installations, which all have the potential of generating adequate revenue to meet the requirements for servicing the loans extended to the Project Company and for providing a reasonable profit to equity investors.

### 2. Main Players

The main players in a BOT project normally will assume the following roles:

(1) The government establishes the BOT policy, ensures economic and financial analysis, identifies and prioritizes BOT projects, and oversees implementation of the project. In particular, the government provides the legal framework and establishes the procuring entity that awards the concession and concludes the Project Agreement with the Project Company. The government provides land (or land use rights) including access roads and environmental permits, access to supplies, guarantees for future revenue, and the possibility of repatriation of profit, effective regimes for security rights and dispute settlement, and, where necessary, currency convertibility.

(2) Private sponsors are members of the consortium that submit a comprehensive proposal and obtain the concession. The sponsors provide the substantial equity, or risk capital required — typically not less than 25 per cent. Sponsors also establish the local project company and in its name secure the additional financing. The lenders are usually given

the right of limited recourse by the sponsors, as initially the assets of the project company are not substantial.

(3) The lenders are indispensable as most of the capital is borrowed. The level of the cash flow, i.e., the difference between the anticipated revenue and the planned expenditures, is decisive for the possibility of obtaining financing and defines the maximum level of credit. An important concept is the debt service coverage ratio which expresses how frequently the cash flow will be adequate to cover debt service payments as they fall due. In addition, the lenders may receive guarantees from the sponsors, security interests in the assets of the project company and in the future revenue generated by the project, or an escrow account may be established.[3]

(4) The project company engages a general contractor to construct the facility which may be a general construction and engineering company with expertise in building the facility, e.g., hydro or thermo power station, toll road or bridge, water plant, port, or telecommunication network installations. A sponsor may also be the general contractor.

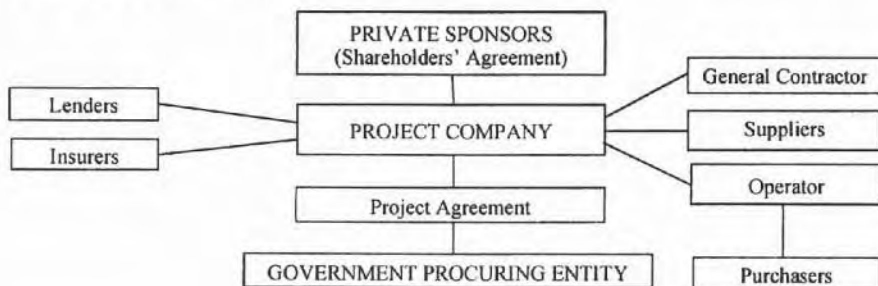
(5) The suppliers provide the major equipment required for the project, such as turbines and other equipment to be installed, as well as tools, materials, and supplies to construct the facility. Normally, the general contractor will enter into purchase and delivery contracts with such suppliers. Other suppliers will deliver fuel and any raw material necessary to operate the facility and, for this purpose, long-term supply contracts will be concluded between them and the operator.

(6) The operator will operate the facility after its completion and until the end of the concession. The operator may be one of the sponsors who for this purpose will enter into an agreement with the project company on the terms and conditions for operating the facility.

(7) The consumers or users will purchase the electricity or water produced, or pay a fee to travel over the bridge or road, or for using the port facilities.

[3] A deposit by the sponsors into an account jointly established by the sponsors and the lender in a neutral bank may secure the lender until all conditions of the loan agreement have been fulfilled and thereafter revert to the sponsors.

Having outlined the roles of the main players, their relationships may be illustrated by the following graph:[4]




## C. APPLICABLE INTERNATIONAL RULES

### 1. International Treaties and Conventions

Among the internationally accepted rules, there are three sets that aspire to be globally applicable:

(1) Government Procurement Agreement (GPA) of the World Trade Organization (WTO);

(2) Model Law on Procurement of Goods, Construction, and Services of the United Nations Commission on International Trade Law (UNCITRAL); and

(3) UNCITRAL's draft of a Legislative Guide on Privately Financed Infrastructure Projects, which is essentially complete although it has not yet been adopted by the Commission.[5]

At the global level, the governing norms and principles must be attributed to the rules of the WTO and its Government Procurement Agreement (GPA). At present, the WTO has 135 states or separate and autonomous customs territories as members and 35, including the People's Republic of China and Chinese Taipei, as observers. Of those members, 26 are parties to the GPA, e.g., Canada, the European Community and its 15 Member States, Hong Kong, Israel, Japan, the Republic of Korea, Liechtenstein, The Netherlands for Aruba, Norway, Singapore, Switzerland, and

[4] "Guidelines for Infrastructure Development through Build-Operate-Transfer (BOT) Projects", United Nations Industrial Development Organization, Vienna 1996, at p. 9.

[5] Official Records of the United Nations General Assembly, A/CN.9/458 and Add., March 1–9, 1999, and A/CN.9/471, Add., December 2 and 9, 1999.

the United States.[6] Additional countries and territories have applied for accession to the GPA, which therefore can be deemed to expound globally accepted standards that also must be taken into account by non-signatory States and customs territories.

UNCITRAL is the United Nations Commission on International Trade Law, an intergovernmental body of 36 independent legal experts selected by the United Nations General Assembly on the basis of geographical rotation and serving for six years.

In 1994, UNCITRAL adopted a "Model Law on Procurement of Goods, Construction and Services".[7] The purpose of the Model Law is to provide guidance to states wishing to enact procurement procedures that conform to generally accepted standards for economy and efficiency, wide participation, competition, fair and equitable treatment of bidders, integrity, transparency, and public confidence in the procurement process. As is the case for other instruments developed by UNCITRAL, the Model Law is designed to be equally acceptable to countries with different economic systems and levels of economic development as well as belonging to different legal systems. Since its adoption, the Model Law has been used by an increasing number of states in establishing or modernizing national legislation on government procurement, especially states undergoing transition to market economy systems and developing countries.

The scope of the Model Law is limited to the procedure and rules governing the bidding process, the selection of the successful bidder, and leading up to the conclusion of a procurement contract. Moreover, the Model Law does not prescribe entirely uniform rules but defines alternative approaches among which individual states can choose when enacting their version at the national level.

In 1996, UNCITRAL decided to prepare a legislative guide to assist states in preparing or modernizing their legislation relevant to BOT and similar, privately financed infrastructure projects. On request of the Commission in 1999, its Secretariat, with the assistance of outside experts and in consultation with other international organizations, prepared and distributed a revised complete draft of a "Legislative Guide on Privately Financed Infrastructure Projects", intended to assist in the establishment of an appropriate legislative framework favorable to privately financed infrastructure projects.

Each chapter of the guide contains a set of legislative recommendations which are followed by notes with an analytical introduction and references to pertinent financial, regulatory, legal, policy, and other issues. The Guide is intended to be used as a reference by national authorities and legislative bodies when preparing

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[6] Aruba became a signatory in 1996. Hong Kong, Liechtenstein, and Singapore in 1997.

[7] Official Records of the United Nations General Assembly, Forty-ninth Session, Supplement number 17; A/49/17, annex 1, at pp. 58–96. Reproduced in *International Legal Materials*, published by the American Society of International Law, at 33 I.L.M. 445 (1994).

new laws or reviewing the adequacy of existing laws and regulations, including whether existing rules are conducive to attracting private capital, national or foreign. While the guide does contain recommendations on specific contractual issues, such as in its Chapter IV on "Construction and Operation of Infrastructure" and Chapter V on "Duration, Extension and Termination of the Project Agreement", it is not intended as a guide on the drafting of agreements or contracts for the execution of any project. Special attention is paid to projects that involve an obligation on the part of the selected investors to undertake physical construction, repair, or expansion of works in exchange for the right to charge a price for the use of the infrastructure facility or for the services or products it generates.

### 2. European Union Directives

Other important sets of rules, such as those of the European Union (EU) Procurement Directives or of the North American Free Trade Association (NAFTA), are regional in scope but rest on the same liberal principles as those of the WTO and its GPA. The European Community (EC) Directives were adopted by the Council of Member States in cooperation with the European Parliament.[8] They set out guidelines that member states must transpose into national law, whether by legislation or regulations. As the scope of Directive 93/36/EEC is limited to procedures for the award of public supply contracts, this Directive is not directly relevant for BOT projects since they involve much more than the purchase of goods. Directive 93/38/EEC on Coordinating the Procurement Procedures of Entities Operating in the Water, Energy, Transport, and Telecommunications Sectors (Utilities Directive) applies, according to its article 2, to both public authorities or entities that undertake activities referred to in the Directive and to entities in the private sector that undertake one or more activities in the covered sectors "and operate on the basis of special or exclusive rights granted by a competent authority of a Member State".

It follows that Directive 93/38/EEC is applicable to procurement by the utility but normally not to the award of a concession for a BOT project. Directive 93/37/EEC concerning Coordination of Procedures for the Award of Public Works Contracts, however, is relevant since it is applicable to "public works concessions" where "the consideration for the work to be carried out consists either solely in the right to exploit the construction or in this right together with payment". Included under the latter Directive's coverage are such civil engineering activities as the construction of roads, bridges, railways, harbors, airports, water supply, and sewerage supplies and the Directive also is applicable to public works contracts for only a part of the activity, such as only the design or execution.

While the scope of direct applicability of the EU rules includes the Members States of the EU or of the European Economic Area (EEA), the normative importance of

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[8] European Community Directives 93/36/EEC regarding public supply contracts, 93/37/EEC regarding public works contracts, and 93/38/EEC regarding the water, energy, transport, and telecommunications sectors, all dated June 14, 1993.

the rules as standard setters also for other countries hardly need be emphasized. Accordingly, for the purpose of defining generally applicable, international rules, the present chapter will examine relevant provisions of the GATT, the GPA, UNCITRAL's Model Law and Legislative Guide, as well as the relevant Procurement Directive of the EU.

## D. THE GENERAL AGREEMENT ON TARIFFS AND TRADE AND THE WORLD TRADE ORGANIZATION AGREEMENT

### 1. GATT Background — Havana Charter for an International Trade Organization

The General Agreement on Tariffs and Trade (GATT) was agreed during negotiations that partially paralleled the negotiations held pursuant to a resolution adopted at the First Session of the United Nations Economic and Social Council (ECOSOC) in London, 1946, for the establishment of a United Nations specialized agency with universal membership under a comprehensive treaty, i.e., the Havana Charter for an International Trade Organization. The negotiation of the Havana Charter took place during 1946–1948 and, although the Charter was adopted, it never entered into force.[9]

On 18 February 1948, the ECOSOC passed a resolution calling for an International Conference on Trade and Employment and, in accordance with the resolution, ECOSOC appointed states as members of a Preparatory Committee and defined its mandate. Already at the first session of the Preparatory Committee, held at Westminster House, London, from October 15 to November 26, 1946, the Procedures Sub-Committee drew up a "Resolution Regarding the Negotiation of a Multilateral Trade Agreement Embodying Tariff Concessions", and "Procedures for Giving Effect to Certain Provisions of the Charter of the International Trade Organization by Means of a General Agreement on Tariffs and Trade Among the Members of the Preparatory Committee". The resolution also noted that the United States government had invited the members of the Preparatory Committee "to meet to negotiate concrete arrangements for the relaxation of tariffs and trade barriers of all kinds and the invitation has been accepted".

The second session of the Preparatory Committee, which was held at the European Office of the United Nations at Geneva from April 10 to October 30, 1947, completed its work on a draft Charter on August 22, 1947 and circulated it to governments as a basis for discussion at the Conference on Trade and Employment convened by ECOSOC at Havana from November 21, 1947 to March 24, 1948. The Conference adopted a Final Act, to which was annexed the agreed text of the Havana Charter for an International Trade Organization as well as a resolution establishing an Interim Commission of the International Trade Organization. Only two countries, however, ratified the Charter, i.e., Australia and Liberia, and the

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[9] Neumann, "The Relationship Between GATT and The United Nations", *Cornell International Law Journal*, Volume 3, Number 1, Winter 1970, at pp. 63–78.

Australian ratification was conditional on similar action by the United States and the United Kingdom. During the time the cold war was intensifying, the Havana Charter was opposed by business groups in the United States. Meanwhile, the GATT became operational and, among others, West Germany became a Contracting Party. On December 6, 1950, the United States' Department of State issued a statement of policy indicating that the Havana Charter would not be submitted again to the United States Congress.

### 2. Establishment of GATT/ICITO

The Second Session of the Preparatory Committee was the forum for the first round of multilateral tariff negotiations between the Contracting Parties of GATT — the signatory governments — which were held at the European Office of the United Nations at Geneva from April 10 to October 30, 1947. The Final Act of the Second Session contained a Protocol of Provisional Application which provided that the Contracting Parties would apply provisionally, on and after January 1, 1948, Parts I and III of the General Agreement, as well as Part II to the fullest extent not inconsistent with existing national legislation. The General Agreement was not made subject to ratification and, as it was accepted definitively only by Liberia and Haiti, the conditions for its definitive entry into force were not met and it continued to be applied provisionally.

The secretariat of the Interim Commission for the International Trade Organization (ICITO), which initially had been made available by the United Nations (and financed by advances from its Working Capital Fund), continued to function and, through an agreement with the Executive Secretary of the Interim Commission, the Secretary-General of the United Nations undertook to continue to provide secretariat services on a reimbursable basis. In turn, the Executive Secretary provided the secretariat services to the Contracting Parties to GATT. In this manner, a *de facto* international organization was established, which came to operate under the acronym GATT/ICITO.

### 3. The Present GATT as Part of WTO

As revised as of April 15, 1994 (General Agreement on Tariffs and Trade 1994), the GATT is one among several multilateral agreements that are annexed to and form integral parts of the Marrakech Agreement establishing the World Trade Organization, signed on April 15, 1994 (WTO Agreement).

### 4. GATT and Government Procurement

The well-known article I.1 of GATT, i.e., the so-called "most favored nation" clause, contains broad provisions setting out requirements that must be met by the Contracting Parties, *inter alia*, when engaging in government procurement. This

provision applies independently of whether a government also is bound by the pluri-lateral GPA, and it reads in part:

> Article I
>
> General Most-Favoured-Nation Treatment
>
> 1. With respect to custom duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, . . . any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

While article I.1 requires that foreign entities are treated equally, article III.1 requires the Contracting Parties to extend national treatment, i.e., treatment not less favorable than that accorded to like products of national origin, to products of other Contracting Parties in respect of:

> . . . internal taxes and other internal charges, and laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use of products.

In general, article III does not apply to government procurement, due to its paragraph 8(a), which reads:

> The provisions of this article shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of products purchased for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale.

It is arguable, however, that procurement for a BOT project falls under the exception of "with a view to use in the production of goods for commercial sale", and the requirement under article III of national treatment would thus be applicable.

Article XVII.1.b of GATT refers to enterprises established, maintained, or enjoying exclusive or special privileges granted by the state and provides that such "State Trading Enterprises" shall make purchases or sales:

> . . . solely in accordance with commercial considerations, including price, quality, availability, marketability, transportation, and other conditions of purchase or sale, and shall afford the enterprises of the other contracting parties adequate opportunity, in accordance with customary practice for participation in such purchases or sales.

Similar to the applicability of article III as discussed above, article XVII may be applicable under the exception in article XVII.2, which reads:

> The provisions of paragraph 1 of this article shall not apply to imports of products for immediate or ultimate consumption in governmental use and not

> otherwise for resale or use in the production of goods for sale. With respect to such imports, each contracting party shall accord to the trade of the other contracting parties fair and equitable treatment.

It follows that with respect to government procurement of infrastructure facilities, the Contracting Parties are certainly bound by the most-favored-nation obligation and probably also required to extend national treatment and grant meaningful market access on a competitive basis to foreign products. Moreover, as a matter of general principle, state trading enterprises must accord fair and equal treatment to all, whether domestic or foreign.

### 5. World Trade Organization

The World Trade Organization was established by the WTO Agreement which entered into force on January 1, 1996. The Agreement itself deals exclusively with organizational and procedural matters and relegates substantive questions to the annexed multilateral and pluri-lateral agreements. It was negotiated as part of the Uruguay Round of Trade Negotiations which concluded on December 15, 1993, and led to the signing of the Agreement on April 15, 1994, at Marrakech, Morocco.

In accordance with the Agreement, the WTO "shall provide the common institutional framework for the conduct of trade relations among its Members in matters related to the agreements and associated legal instruments included in the Annexes to this Agreement". The Agreement distinguishes between the annexed multilateral agreements constituting integral parts of the Agreement and binding on all WTO members and the annexed pluri-lateral agreements which "are also part of this Agreement for those Members that have accepted them, and binding on those Members". The distinction is significant considering that GATT, as amended in the 1994 version, is annexed as a multilateral agreement thus forming an integral part of the WTO Agreement, while GPA merely is annexed as a pluri-lateral agreement binding only on the members having acceded to it.

WTO is the formally established successor to the informally established organization GATT/ICITO. Article XVI of the WTO Agreement provides that the secretariat of the latter "to the extent practicable shall become the Secretariat of the WTO" and that "the WTO shall be guided by the decisions, procedures, and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947".

Original members of the WTO are, in addition to the EU, those states which were Contracting Parties to GATT on January 1, 1996, i.e., the date of entry into force of the WTO Agreement. As China is not considered to have become a contracting party to GATT, the possibility of it becoming a member are governed

by the provisions on accession in article XII.1 and 2 — including the requirement of a prior agreement with WTO on the terms of the accession, reading as follows:[10]

Article XII. Accession

1. Any State or separate customs territory possessing full autonomy in the conduct of its external commercial relations and of the other matters provided for in this Agreement and the Multilateral Trade Agreements may accede to this Agreement, on terms to be agreed between it and the WTO. Such Accession shall apply to this Agreement and the Multilateral Trade Agreements annexed thereto.

2. Decisions on accession shall be taken by the Ministerial Conference. The Ministerial Conference shall approve the agreement on the terms of accession by a two-thirds majority of the Members of the WTO.

3. Accession to a Pluri-lateral Trade Agreement shall be governed by the provisions of that Agreement.

As a signatory to the Final Act of the Havana Conference, however, China enjoyed observer status in GATT under rule 8 of the Rules of Procedure for Sessions of the Contracting Parties, which read:

Rule 8: The representatives of countries signatories to the Final Act adopted at the conclusion of the United Nations Conference on Trade and Employment at Havana which have not become contracting parties may attend meetings in the capacity of observers participating in the discussions without the right to vote.

In 1986, China requested to return to GATT as a Contracting Party and, in 1987, GATT established a working party to study resumption of China's membership. Since the establishment of the WTO in 1996, these efforts have been directed at membership in the WTO. In this connection, it should be recalled that in accordance with article XII of the WTO Agreement, the acquisition of membership by accession must include both the WTO Agreement and the annexed Multilateral Trade Agreements, but not necessarily the GPA since it is a pluri-lateral agreement that does not form an integral part of the WTO Agreement.[11]

On behalf of the WTO, decisions on accession are to be taken by the Ministerial Conference, which shall approve the agreement on the terms of accession by a two-thirds majority of the members of the WTO. According to article IV, the Ministerial Conference is composed of representatives of all members and shall meet at least once every two years. Concerning decision-making, article IX.1 provides that:

1. The WTO shall continue the practice of decision-making by consensus followed under GATT 1947. Except as otherwise provided, where a decision

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[10] Apparently, the focus of current membership negotiations is on the granting of reciprocal trading rights, including access to the internal, commercial markets.

[11] China has stated that it is not interested in joining the Agreement on Government Procurement.

> cannot be arrived at by consensus, the matter at issue shall be decided by voting. At meetings of the Ministerial Conference and the General Council, each Member of the WTO shall have one vote. Where the European Communities exercise their right to vote, they shall have a number of votes equal to the number of their member States which are Members of the WTO. Decisions of the Ministerial Conference and the General Council shall be taken by a majority of the votes cast, unless otherwise provided in this Agreement or in the relevant Multilateral Trade Agreement.

Accordingly, China's request for membership in the WTO must be decided by the Ministerial Council, which must approve the agreement on the terms of the accession and the membership issue. The agreement should be decided by consensus or approved by two-thirds of the members and the accession itself by a majority of the votes cast.

## E. AGREEMENT ON GOVERNMENT PROCUREMENT

### 1. Conduct of Trade Relations

The present Agreement on Government Procurement (GPA) was negotiated in parallel with the Uruguay Round of Trade Negotiations. The negotiations concluded on December 15, 1993, and signatures were affixed on April 15, 1994, at Marrakech. It entered into force on January 1, 1996 and replaced the previous GPA (Tokyo version) which had been concluded in 1979 and came into force in 1988.

For each signatory, the coverage of the GPA is determined by lists of specified government entities and of specified goods, construction, and services. The present (1996) GPA extended the coverage to specified entities at the sub-central level, such as federal states, provinces, prefectures and municipalities, parastatals (such as utilities), and services and construction in addition to the purchases of goods. For most parties, there are minimum value thresholds of Special Drawing Rights (SDR) 130,000 for goods and services procured by the central government, SDR 200,000 for goods and services procured by sub-central government entities and SDR 400,000 for most goods and services procured by parastatals.

For construction services, the limit for most parties is SDR 5 million, while for Israel it is SDR 8.5 million and for Korea and Japan SDR 15 million. Excluded from the list is tied aid and certain defense procurement. With regard to BOT infrastructure projects, however, the value of concession agreements, construction contracts and purchase agreements normally will exceed these limits, and procurement of such projects thus will be within the scope of the GPA.

As mentioned above, GATT itself excludes government procurement, i.e., procurement of products for governmental purposes and not for commercial resale or for use in the production of goods for commercial sale, from the applicability of the basic principle of national treatment. Since, however, procurement by governments of goods and services typically accounts for 10 per cent of a country's GDP, preferential government procurement policies would affect many billions of dollars

worth of trade: it is estimated that under the 1988 GPA the total value of contracts awarded was SDR 39.6 billion, of which contracts below the threshold of SDR 130,000 accounted for SDR 17.3 billion and contracts above totaled SDR 22.3 billion. Estimated coverage under the present GPA is considerably higher, namely, SDR 350 billion in 1996, and, thus, exclusion of such procurement would run counter to the objectives of GATT.

In consequence, the 1996 GPA aims to bring government procurement policies and practices into conformity with the basic principles of GATT through reciprocal opening of markets, curtailment of discrimination, and injection of transparency. In addition, the 1996 GPA provides that laws, regulations, procedures, and practices may not be prepared, adopted, or applied to foreign or domestic products or services, or to foreign or domestic suppliers or service providers, so as to afford protection to domestic products, services, suppliers, or service providers and, to promote implementation of the agreed objectives and principles, it establishes procurement procedures which the parties are bound to transpose into national legislation.

## F. COMMON PRINCIPLES AND NORMS FOR INTERNATIONAL COMPETITIVE BIDDING

### 1. Principles and Norms

This section will identify certain principles and norms that are common to UNCITRAL's Model Law, UNCITRAL's Legislative Guide, the GPA, and the EU's Directive 93/37/EEC (Public Works Directive), while at the same time being relevant for the conduct of competitive bidding for a BOT infrastructure project.

Depending on which international agreements the procuring government has accepted, such principles and norms may be legally binding or merely advisable in order for the procurement process to meet with international acceptance, to be effective, and to minimize exposure of the procuring entity to claims from and disputes with bidders. Even when not formally binding, however, these principles and norms are advisable.

In any event, a comparative study of the generally accepted and widely enacted international rules would be an indispensable basis not only for a government in an emerging country when preparing a BOT procurement procedure, but also for a consortium in preparing its bid and participating in any ensuing negotiations. In this connection, however, regard should be had to the fact that since the main objectives of the various international instruments may be the promotion of free trade and access for investors, which consequently have been well regulated, less emphasis has been given to adopting uniform rules in areas such as evaluation criteria and methods, the contents of solicitation documents, including standard contractual clauses, as well as the important issue of review of decisions, including the award decision, of the contracting authority and third party dispute settlement.

Some governments, in particular in major countries, may prefer the enactment of a comprehensive law on government procurement procedures, including in particular competitive bidding at the international level, to be followed by secondary legislation (such as decrees, ordinances, or regulations) setting out more detailed provisions as may be appropriate to each individual BOT project, while other governments may wish to determine procurement procedures on a case-by-case basis. While the Congress of the Philippines has adopted a comprehensive Act[12] on the subject, the Government of China has preferred to first receive advice from a number of international organizations and consulting firms.

The World Bank and UNIDO have had leading roles, and have collected practical experience. Thus, with technical expert assistance from UNIDO, in 1994 a provisional decree[13] with "BOT-Tentative Provisions" as well as sets of standardized Concession Agreements were prepared for the State Planning Commission and submitted to the State Council (the government) and the People's National Congress (the legislature) for approval. Further regulation of the matter took place on August 21, 1995, when the State Planning Commission, Ministry of Power Industry, and Ministry of Communications issued a "Notice on Certain Issues Concerning the Examination, Approval, and Administration of Experimental Foreign-invested Concession Projects". The provisional decree will be reviewed when it has been tested through five pilot projects implemented with assistance from UNIDO: two coal-fired power stations, a bridge over the Yangtze, and two water treatment plants, all of which may be completed in 2000. The regulatory environment at present also includes "Tentative Procedures on Promulgated by the State Planning Commission (now the State Development and Planning Commission) and the State Administration of Foreign Exchange (SAFE) and "Procedures for the Administration of Borrowing of International Commercial Loans by Organizations in China", effective from January 1998, promulgated by SAFE on September 24, 1997.

While only the GPA employs the concepts of "national treatment" and "most-favored-nation treatment", both UNCITRAL's Model Law and Legislative Guide, the GPA, and the EU's Public Works Directive endorse and require the application of general principles that in practice are likely to have similar effects. Thus, UNCITRAL's Model Law requires that bidders be given "fair and equal treatment" and the EU's Utility Directive "equal treatment". UNCITRAL's Legislative Guide, Recommendation 1, merely says that "undesirable restrictions to private sector participation in infrastructure development and operation should be eliminated", but the implication is that that the reference to the private sector is not limited to domestic entities.

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12 Republic Act Number 7718 (amending certain sections of Republic Act Number 6597, entitled "An Act Authorizing the Financing, Construction, Operation, and Maintenance of Infrastructure Projects by the Private sector, and for Other Purposes").

13 "Provisional Decree for Concession Projects with Foreign Investment".

The geographical scope of applicability of the rules is, of course, variable. UNCITRAL's Model Law and Legislative Guide do not define it, while in the case of the GPA and the EU Directive, it depends on which States are parties to the particular instrument.

UNCITRAL's Model Law allows for the possibility of granting a margin of preference for domestic construction contractors, for suppliers of domestically produced goods, or for the benefit of domestic suppliers of services.[14]

Also, the principles of non-discrimination and transparency are embodied in all four instruments. UNCITRAL's Legislative Guide urges in Recommendation 1 that "the legislative and institutional framework for implementation . . . should ensure transparency, fairness, and the long-term sustainability of projects", and Recommendation 14 calls for "the selection of the concessionaire through transparent and efficient competitive procedures adapted to the particular needs of privately financed infrastructure projects".

Article 4.2 of the EU's Utility Directive plainly provides that "contracting entities shall ensure that there is no discrimination between different suppliers, contractors or service providers", and article 22.4 of the Public Works Directive requires Member States to "ensure that contracting authorities issue invitations without discriminations to those nationals of other Member States who satisfy the necessary requirements and under the same conditions as to its own nationals".

## 2. Scope and Coverage

While UNCITRAL's Model Law and Legislative Guide leaves it to each enacting government to define the covered procuring entities and activities, the Model Law defines "procurement" as "the acquisition by any means of goods, construction, or services". The Legislative Guide in its Recommendation 2 states that "the law should identify the public authorities of the host country (including, as appropriate, national, provincial, and local authorities) which are empowered to enter into agreements for the implementation of privately financed infrastructure projects" and in Recommendation 3 says that "privately financed infrastructure projects may include concessions for the construction and operation of new infrastructure facilities and systems or the maintenance, modernization, expansion, and operation of existing infrastructure facilities and systems".

The GPA is applicable to "any law, regulation, procedure, or practice regarding any procurement by entities covered" and to "procurement by any contractual means, including through such methods as purchase or as lease, rental or hire purchase, with or without an option to buy, including any combination of products and services".[15]

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[14] UNCITRAL Model Law, section III, article 34.4.d.

[15] Government Procurement Agreement, article I.1 and I.2.

Accordingly, a BOT concession agreement could be covered in an enactment of UNCITRAL's Model Law, should be covered by enactment of the recommendations in the Legislative Guide, and is covered by the GPA. With regard to the latter, it is further relevant for BOT projects that all types of construction services for the realization of civil or building works are included under the GPA by its Annex 5 (although certain limits are expressed in the respective country annexes). As discussed in paragraph 12 above, concession agreements and construction services are, respectively, included under the EU's Public Works Directive (93/37/EEC) or the Utilities Directive (93/38/EEC).

With respect to scope and coverage, attention should be paid to the definition of the concept of government procurement. As discussed above, government procurement is defined in articles III.8 and XVII.2 of the GATT by referring both to the legal status of the procuring entity and to the purpose of the procurement, namely, whether it is "for governmental purposes", "for immediate or ultimate consumption in governmental use", or "for commercial resale or for use in the production of goods for commercial sale".

A similarly structured definition is found in the EC Directive on procurement by public utilities, which defines the scope of its application as follows: contracting entities may be either public authorities or undertakings or non-public authorities or undertakings which operate on the basis of special or exclusive rights granted by a competent authority of the State concerned. In either case the Directive applies to the enumerated activities:

(1) The provision or operation of a fixed network for, or the supply of, drinking water, electricity, gas, or heat;

(2) Exploring for or extracting oil, gas, coal, or other solid fuels;

(3) Provision of airport, maritime, or inland port or other terminal facilities to carriers;

(4) Operating a network providing public transportation services by railway, automated systems, tramway, trolley bus, bus, or cable; and

(5) Provision or operation of public telecommunication networks or services.

Notwithstanding these provisions in the Utilities Directive, it is recalled that, as far as the concession of a BOT project is concerned, it appears as discussed above that the Public Works Directive is more likely to be applicable.

While, in the EU, most utilities traditionally have been government owned or controlled and some have been privatized in recent years, in the United States many utilities have long been in the private sector. As, moreover, United States legislation defines a government procurement entity solely on the basis of its legal status, in the

framework of GATT, agreement on coverage could only be reached through the device of adding distinct annexes in respect of each party to the GPA, which enumerate the entities falling under the concept of government procurement and specify the products and services covered by the GPA. A decisive reason why it was found necessary to enumerate expressly the coverage of the GPA in respect of each party is the policy requirement of achieving an economic balance between the concessions made, which is ensured by letting the coverage reflect an equal share of the public procurement market of each party.

An obvious complication for the realization of this objective is that national economies are not structured in a uniform way. In particular, there are significant differences between various states regarding the relative shares of the economy, including the producing entities that are owned by the private as compared to the public sector, and there are a variety of important examples from several countries of entities with a legal status or ownership that places them partially in the public and partially in the private sector. A case in point is China, where publicly owned enterprises continue to constitute a very large — though diminishing — share of all enterprises. To this must be added the numerous town and village enterprises. In comparison, the United States is at the other end of the spectrum since almost all enterprises in the United States are privately owned. If, therefore, the legal status of a given enterprise is employed as the main criterion in defining government procurement, the coverage in the United States would include a much smaller share of the total economy than in the case of a country such as China.

With this background, it is understandable that the GPA gives more weight to the purpose of the procurement: whether it is for a governmental purpose and use, rather than for a commercial purpose and consumption, and that for the sake of simplicity and clarity use is made of enumeration of entities, products, and services. In any event, the final determination of scope and coverage will be the outcome of a negotiation, in which the relative strength of the commercial interests of the parties would be measured.

In this connection, it may be mentioned that the GPA under certain conditions permit bilateral arrangements between a state party and a non-party. In accordance with its article XVII, each party shall encourage its covered procurement entities to indicate "the terms and conditions, including any deviations from competitive tendering procedures or access to challenge procedures, under which tenders will be entertained from suppliers situated in countries not parties to this agreement". The non-party shall, however, ensure a minimum level of transparency and therefore must:

(1) Specify its contracts as required by the GPA's rules on technical specifications;

(2) Publish procurement notices as required by the GPA; and

(3) Ensure that its procurement regulations shall not normally change during a procurement and, if they do, ensure satisfactory means of redress.

Non-parties that meet the transparency conditions may so inform the members of the government procurement committee and participate in the committee as observers.[16] Article XVII thus makes it possible for one or more parties to the GPA to enter into negotiations with one or more non-parties on granting reciprocal procurement opportunities.

### 3. Methods of Procurement

Depending on the object of procurement, UNCITRAL's Model Law provides for distinct methods of procurement. Unless otherwise provided, for goods and construction open tendering shall be used, i.e., the procuring entity shall "solicit tenders or, where applicable applications to prequalify by causing an invitation to tender or an invitation to prequalify, as the case may be, to be published" in the *Official Gazette* or other official publication as well as in a relevant journal of wide circulation.[17]

When the goods, construction, or services are available only from a limited number of suppliers, or in case of extreme urgency, the invitations to tender may be issued only to those from whom the requirements are available. Moreover, when it is not feasible in the solicitation documents to provide a definitive description of all the conditions, including in particular the technical specifications, or where alternative solutions are sought, or where it is necessary to negotiate, the Model Law permits the use of either two-stage tendering,[18] competitive negotiation,[19] or request for proposals.[20]

UNCITRAL's Legislative Guide endorses, in its Recommendation 19, the making use of a two-stage procedure "when it is not feasible for the contracting authority to formulate project specifications or performance indicators and contractual terms in a manner sufficiently detailed and precise to permit final proposals to be formulated". In that event, the bidders should first submit proposals relating to "output specifications and other characteristics of the project as well as to the proposed contractual terms", and a meeting of the bidders may be convened to clarify

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[16] According to the Government Procurement Agreement, article XXI; the government procurement committee is composed of representatives from each of the Parties and has the mandate "to consult on any matters relating to the operation of this Agreement or the furtherance of its objectives, and to carry out such other responsibilities as may be assigned to it by the Parties".

[17] UNCITRAL Model Law, article 24.

[18] UNCITRAL Model Law, articles 19 and 46.

[19] UNCITRAL Model Law, articles 19 and 49.

[20] UNCITRAL Model Law, articles 19 and 48. The method of request for quotations is not considered here, since it is used for readily available standard goods.

questions arising from the initial request for proposals. Following an examination of the proposals received at the first stage, the procuring entity may revise the specifications and contractual terms to be included in the final request for proposals. The evaluation criteria should be the same, however, at both stages.

According to UNCITRAL's Model Law, the method of competitive negotiations requires that "the procuring entity shall engage in negotiations with a sufficient number of suppliers or contractors to ensure effective competition", but, in view of the magnitude and complexity of BOT projects, there likely will be far too many variables for it to be feasible to achieve effective competition by parallel negotiations. Realistically, a substantial loss of transparency is probable and the risk of corruption would be heightened. The Legislative Guide, more appropriately, does not attempt to regulate how many negotiations shall be held and simply views direct negotiations as permissible when competitive bidding for exceptional reasons is not feasible.

As is the case for tendering, the Model Law requires the procuring entity, when using the request for proposal method, to first advertise the procurement opportunity in a trade, technical, or professional journal of wide circulation, seeking expressions of interest in submitting a proposal. Thereafter, proposals shall be requested from as many as practicable, but at least three.

Contrary to tendering, where the Model Law offers a choice between only two sets of evaluation and selection criteria,[21] the procuring entity shall determine itself the criteria which shall be stated when the request for proposal method is used. In addition to this flexibility, the procuring entity having requested proposals "may engage in negotiations with suppliers or subcontractors with respect to their proposals and may seek or permit revisions of such proposals", provided that confidentiality is preserved and that all bidders whose proposals have not been rejected will have the opportunity to negotiate.

Tendering permits neither negotiations nor any change in a matter of substance, including price, and only purely arithmetical corrections shall be corrected by the procuring entity. Considering these differences, and taking into account the size and complexity of BOT projects, it is not surprising that the Legislative Guide does not refer to the formal tendering procedure, but to the request for proposals method, and that its Recommendations 26 and 27 expressly permit negotiations with the best rated bidder.

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[21] According to UNCITRAL Model Law, article 34.4.b, "The successful tender shall be: (i) The tender with the lowest tender price, subject to any margin of preference; (ii) If the procuring entity has so stipulated in the solicitation documents, the lowest evaluated tender ascertained on the basis of criteria specified in the solicitation documents, which criteria shall to the extent practicable, be objective and quantifiable, and shall be given a relative weight in the evaluation procedure or be expressed in monetary terms wherever practicable".

The GPA and the EU's Public Works and Utilities Directives essentially follow UNCITRAL's Model Law and Legislative Guide in setting out the methods of procurement, except for two-stage tendering, which is not mentioned. All instruments require that the procuring entity normally shall publish a notice of the intended procurement, but they do not express any preference between open and restricted competitive procedures. Negotiated procurement procedures do not require publication of advance notice and may be used only in the enumerated, but broadly defined situations.

### 4. Prequalification

Detailed provisions on prequalification are found in UNCITRAL's Model Law and Legislative Guide.[22] While the GPA and the EU's Public Works and Utilities Directives do not describe any prequalification stage, the conduct of prequalification are compatible with their provisions on restricted tendering or calling for proposals. The GPA and the Utilities Directive are mainly focusing on the establishment of listings of generally qualified suppliers prior to any concrete procurement opportunity but, due to the unique nature of BOT projects, these provisions are not relevant to project financing.

According to the Model Law, prequalification proceedings may be conducted with a view to "identifying, prior to the submission of tenders, proposals or offers, . . . suppliers and contractors that are qualified". For this purpose, the procuring entity shall on request provide the prequalification documents that set out the procedure and all substantive conditions for prequalification, including any legal documents. The documents must include, *inter alia*, "a summary of the principal required terms and conditions of the procurement contract to be entered into" and, to the extent known, a description of the goods, construction, or services required, deadlines for delivery or completion, and the evaluation criteria. The Legislative Guide in its Recommendations 15–17 addresses "preselection of bidders" and provides that the bidders should demonstrate that they meet the preselection criteria that are considered appropriate to the particular project, such as the professional and technical qualifications, human resources and equipment required, the necessary managerial ability, capability to sustain the financing, reliability, and relevant prior experience.

The bidders should be allowed to form consortia already during the prequalification or preselection stage, although each bidder may participate in only one bidding consortium. To conclude this stage, the procuring entity should establish a short list of those bidders who are approved and therefore will be requested to submit proposals. The evaluation criteria used for prequalification should remain the same for the subsequent evaluation of competitive proposals.

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[22] UNCITRAL Model Law, articles 6 and 7.

It is generally advisable for BOT projects to go through prequalification, preceded by publication of an open invitation to express interest in participating in the prequalification. Although not all interested potential bidders may be declared qualified and thus become entitled to be invited to submit a fully-fledged bid, participation in prequalification proceedings is not as burdensome and costly as the subsequent submission of proposals — possibly in two stages. In addition, it will be in the best interest, both of the procuring entity and of the potential bidders, that the field is narrowed down to those truly qualified to bid, before further efforts are invested. Competition is thereby increased and the quality of bids eventually received is likely to be improved.

## 5. Time Limits

The time to be permitted for the various stages, such as publication of notice, prequalification, submission of proposals, and evaluation, depends on the nature of the object of the procurement. The deadlines stated in various provisions of the GPA and the EU's Public Works and Utilities Directives are not relevant for project financing in states that are not bound by these instruments, firstly, because they express minimum periods and, secondly, because a considerably longer time must necessarily be allowed for a BOT project.

This is especially true for the time to be granted invited consortia to prepare and submit their proposals which — as will be explained — not only requires detailed coverage of all technical and contractual aspects, but also consultations and negotiations with investment banks or other financial institutions to secure advance commitment of funds.

The following schedule may serve to illustrate how much time may typically be required for a power station:

| | Months |
|---|---|
| Publication of notice and submission of expression of interest | 1 |
| Evaluation of expressions of interest | 1/2 |
| Distribution of prequalification documents and submission of prequalification statements | 2 |
| Evaluation of prequalification documents | 1/2 |
| Distribution of solicitation documents for bids and submission of bids | 6 |
| Evaluation of bids, clarifications, and negotiations | 3 |
| **TOTAL MONTHS UNTIL AWARD:** | **13** |

Special factors, such as difficult environmental conditions or any other complications, will add to the time that will be required for any particular stage. There normally would not be any additional cost to the project involved in allowing additional time, but a slow pace or excessive time periods may cause otherwise interested consortia to dissolve or lose their interest. The award is only an intermediate step as there are several crucial subsequent stages before the deal is done and physical construction can commence.

### 6. Solicitation Documents

All the international instruments discussed here employ the technique of enumerating in considerable detail all that must be contained in an invitation to tender or in a request for proposals.[23] These listings are useful and should be consulted when preparing the solicitation documents, although it will be obvious that only those in Recommendation 20 of the Legislative Guide have been cast with project financing specifically in mind.[24] Accordingly, this and the following sections will seek to address those aspects that are especially important for such projects.

It is fundamental that the solicitation documents must include all the information, instructions, and data that the invitee will need to be in a position to submit a well-prepared proposal. The solicitation documents also serve as the basic tools of the procuring entity in guiding the competitive process towards a clear and correct award decision, followed by timely conclusion of a mutually advantageous concession agreement, reasonable financial arrangements, and effective contracts. In general, it is preferable to spend more time and effort on preparing a complete set of comprehensive solicitation documents than to postpone choices and decisions until a later stage in the process, since any hope of facilitating and/or accelerating the process in this manner regularly leads to deep disappointments. The following sections discuss the essential documents:

#### *a. Instruction to Bidders*

The instruction will inform the bidders of the procedure to be followed and must address in detail important formalities such as deadlines, signatures, stages of the process, use of sealed envelopes for bids, form of bid bond, claims, and dispute settlement procedure. In addition, the instructions must address and clarify essential substantive aspects, such as the evaluation and selection criteria, legal liabilities and

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[23] UNCITRAL Model Law, article 27.

[24] "Recommendation 20. The final request for proposals should include at least the following: (a) General information as may be required by the bidders to prepare and submit their proposals; (b) Project specifications and performance indicators, as appropriate, including the contracting authority's requirements regarding safety and security standards and environmental protection; (c) The contractual terms proposed by the contracting authority; (d) The criteria for evaluating the proposals, the relative weight to be accorded to each such criterion and the manner in which they are to be applied in the evaluation of proposals".

responsibilities of the bidders and of the procuring entity, as well as sanctions for breach of the required procedure and of the trust that is essential between contracting parties.

It is unlikely that any international or national legal instrument will be readily available, which authoritatively regulates all matters relevant to the particular BOT project in an appropriate and clear manner that can be readily understood also by non-lawyers. Therefore, the instructions to bidders must serve as a single, self-contained document that draws all important rules together.

*b. Prequalification of Consortia and Participation*

As it cannot be assumed that the identity of the firms making up the various consortia is kept confidential, it is necessary to prohibit collusion between the bidders both during and after the prequalification stage.

Therefore, each consortium or firm must be required to prepare its bid or participation in a consortium independently, i.e., without entering into any consultation or understanding with another consortium and/or firm participating in another consortium at the prequalification stage or, after prequalification, with another consortium or firm that has been accepted as prequalified. If collusion occurs, the bid or bids involved shall be held invalid and the bid bond forfeited.

*c. Inducements and Misrepresentations*

To ensure the integrity of the process, it is necessary — in addition to providing transparency — to impose sanctions in case any bidder should offer a bribe of any kind to an official or a consultant of the procuring entity, or if the bid is found to contain willful misrepresentations.

Apart from such legal sanctions as may be available under applicable national law, the same effective sanctions as in the case of collusion should be stipulated, namely, invalidation of the bid and forfeiture of the bid bond.

*d. Prequalified Bidders*

To ensure cohesion and strengthen the mutual commitments among the firms constituting a consortium, it is advisable to require the members of a consortium to accept to be liable jointly and severally for the obligations of the consortium arising out of the bid.

Due to the importance of effective competition, it is not desirable for the composition of a consortium to change after its prequalification. Addition of members should be permitted, however, provided the new member is not a firm that has previously participated in the prequalification process. Replacement of a member by a subsidiary or affiliated firm should require prior approval of the procuring entity. Finally, each

member should be required to promptly inform the procuring entity of any material and adverse change occurring after submission of its prequalification statement.

### e. *Opening of Bids*

Among the most important measures to ensure fairness in the competitive bidding process is the transparency afforded by formal opening of the bids in the presence of representatives of the bidders. At the opening, an initial review of the bids received in time is undertaken to confirm they are complete, have been properly signed, and that any required bid bond is included.

Thereafter, the names of the bidders, the prices offered, and other essential conditions in the bids shall be read out to those attending the opening. Those bids not opened and read out at the opening shall not be considered. Provisions to this effect are found in UNCITRAL's Model Law, article 33, and in the GPA, article XIII.

### f. *Technical Description and Specifications*

Among the key provisions to a successful project are the quality of the technical description and specifications to be included with the request for proposals. This documentation must be comprehensive,[25] but should not attempt to provide technically detailed blueprints for the actual construction. That will be the responsibility of the construction company that will be selected later on. The emphasis rather should be on stating exact performance requirements and benchmarks as well as quality and safety conditions, including environmental restrictions that the bid must comply with.

The technical specifications should contain a description of the site where the project shall be implemented, covering the physical characteristics, including relevant findings from geological and hydrological surveys and environmental sensitivity assessments. If there are existing structures that must be included in the project, by upgrading, they also must be included in the technical description and specifications.

In this connection, the instructions to bidders should emphasize that the description and specifications do not constitute any warranty as to accuracy or adequacy for the bidder's purposes, i.e., preparation of the proposal and implementation of the project. All operational risks must be assumed by the bidding consortium and subsequently by the project company. While the procuring entity should not be reluctant to make available all kinds of technical data in its possession or under the government's control, care must be taken not to extend any guarantee, express or implied, as to the quality of the data except that they have been offered in good faith. Where it would be helpful to the bidders, visits to the site should be

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[25] An inclusive definition is in EC Directive 93/38/EEC of June 14, 1993, article I.8. Other relevant provisions are the GPA, article VI and UNCITRAL's Model Law, article 16.

arranged for representatives of the participating consortia and time should be allowed for them to do or obtain their own surveys and assessments by technical experts retained by themselves.

### g. *Model Texts*

To guide the bid preparations by the various consortia towards the submission of proposals susceptible to comparative evaluation in accordance with uniform, pre-set criteria, the procuring entity should prepare and include among the solicitation documents a Model Text of the Concession Agreement and of other key contractual documents such as bid and performance bonds and any "Off-Take Agreement", such as a power purchase agreement in case of a power plant. This will considerably reduce the procuring entity's exposure to unexpected and unusual contractual conditions and can only be regarded as fair to the bidders.

A related essential purpose of drafting these documents already at the beginning of the process is to state in the clearest possible terms the fundamental, mutual rights and obligations that will be assumed by the government and the concessionaire. On this basis, it will be ensured that all the bidders are on the same level and the whole process will be greatly simplified so that the time needed until award, financial closing, conclusion, and entry into effect of the project agreement and other contracts is as short as possible.

### h. *Essential Provisions in the Project Agreement*

UNCITRAL's Legislative Guide focuses in its Recommendations 57–59 on certain essential features of the project agreement. In addition to setting out the primary mutual rights and obligations of the parties, provisions must be included to address the project company's potential failure to perform and to provide the remedy of stepping into the role of the project company. It is recommended that, in the event of serious failure of the project company to perform, the procuring entity should have the right to take over the operation of the facility, on a temporary basis, for the purpose of ensuring the effective and uninterrupted delivery of the service. The project agreement should further stipulate a right for the lenders, with the consent of the procuring entity, to appoint a new concessionaire to perform under the same project agreement, if the initial concessionaire (the project company) seriously fails to deliver the services required or "if other specified events occur that could justify the termination of the Project Agreement". It would appear to be advisable in most cases to define the "other specified events" in a manner that fully protects the lenders' interests in ensuring a stable and adequate revenue stream for the servicing of the loans and possibly to provide that the procuring entity may not unreasonably withhold its consent to the appointment of a new concessionaire.

The time that passes after issuance of requests for proposals until commencement of physical work — and even more the time until completion and commissioning of the project facility — is a major variable factor in the determination of the overall cost of the project, *inter alia*, due to the financial margins charged to cover inflationary

factors, exchange rate fluctuations and, especially, interest charges and opportunity cost of the capital required. As the consumers or users in the country of the project, rather than the concessionaire, will ultimately be burdened with the overall cost, the government should strive to shorten the time needed until completion.

The steps that follow the award of a project for a power station to the selected consortium, and the time typically required, can be outlined in a schedule as follows:[26]

| | **Months** |
|---|---|
| Incorporation and Registration of Project Company | 2 |
| Negotiation and Finalization of Construction Contract and Operation and Maintenance Contract. Submission for Approval by the Government | 6 |
| Finalization of Financing Documents, including Performance Bond, and submission for Approval by the Government | 6 1/2 |
| Execution of Signature of Project Agreement and of Power Purchase Agreement by Project Company | 7 |
| Financial Closing | 7 |
| Effective Dates of Project Agreement, Power Purchase Agreement, Construction Contract, and Operation and Maintenance Contract | 7 |
| **TOTAL MONTHS:** | 7 |

The complete time schedule should be set out in the instructions to bidders and made mandatory for all participants, including the procuring entity and relevant government agencies. All together, as can be seen, around 20 months may elapse from the date invitations to bid are issued until the effective date of the project agreement and the main contracts.

### *i. Presentation of Bids and Evaluation*

As is normal for major projects, the bids shall be submitted in two sealed envelopes and be accompanied by a bid bond in a meaningful amount, such as three per cent of the estimated (construction) cost. The bids should be valid for a period estimated to be fully adequate to undertake the evaluation, decide on the award, and have it accepted by the successful bidder.

It also should be possible for the procuring entity on request to obtain a reasonable extension of the validity period. All bid bonds should be valid for several weeks longer than the bids, and the bid bond posted by the successful bidder should remain

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[26] The effective dates shall be as agreed between the parties and cannot precede the financial closing. To avoid accumulation of costs, the dates should be as soon as possible after financial closing.

valid until the project company provides the performance bond that will be required under the project agreement. The first envelope must contain:

(1) General information regarding the identity, experience, and legal status of the bidder, including a copy of the "shareholders agreement" or other agreement concluded between members of the bidding consortium;

(2) The technical bid; and

(3) The legal bid.

The technical bid shall conform and be responsive to all the technical criteria, performance, and quality specifications required by the solicitation documents. Similarly, the legal bid shall convey the bidder's acceptance in advance of the Model Texts (Concession and Power Purchase Agreements), and it should be provided that, if the bidder wishes to modify the Model Texts, he shall set out the desired changes as annotations to the Model Texts and explain the reasons for such proposed deviations and the net benefits that would result for the bidder and for the government (including the ultimate consumers or users) as well as the effect on pricing and on the bidder's financing. The second envelope must contain the financial bid which shall include, *inter alia*:

(1) The fee, tariff, or other (unit) price to be paid for the electricity made available;

(2) The proposed duration of the power purchase agreement, which shall not exceed the repayment period for the loans to be contracted by the consortium to finance the project;

(3) The time required by the consortium between award and financial closing to achieve the necessary financial arrangements. A maximum period, such as seven months, should be stipulated in the instructions to bidders;

(4) Commitment letters (preferably binding) from banks or other financial institutions, detailing the loans and any credit support needed by the lenders;

(5) A financial report containing a financial plan for the project describing the estimated total investment costs, operating costs, annual costs, sources and uses of funds, capital costs, risk allocation analysis (referring to equity holders, lenders, insurers, or contractors), capital structure, projection of annual income and cash flow, balance sheets, debt service coverage ratio, and debt repayment schedule;

(6) The construction period; and

(7) Any credit support required by the bidder to support the off-take purchaser's obligation under the power purchase agreement to pay for the electricity made available by the project company.

The procedure and criteria for evaluation of bids, as described above, shall be stated in the instructions to bidders. This information is needed by the bidders to prepare their bids and for all concerned to avoid or minimize the exposure to claims that the award has gone to the wrong bidder.

The evaluation commences with the opening of only the first envelope. At this stage, the evaluators must review the general information and the technical and legal bids with a view to ascertaining whether the offers are complete and whether they conform to and are responsive to the requirements stipulated in the solicitation documents. In case either the general information or the technical or legal bid is deemed not to be complete, responsive, and acceptable, the entire proposal shall be rejected and no evaluation of the financial bid shall take place.

For those proposals not rejected, on the basis of the contents of the first envelope, the second envelope shall be opened, and the financial bid shall be evaluated in accordance with the pre-established criteria. While it would be technically possible to limit the financial evaluation to establishing the lowest tariff offered, this is not considered adequate for BOT projects. Instead, several factors are to be taken into account, separately scored, and weighted to arrive at an overall number of points. Typical factors to be considered are:

(1) The proposed fee or tariff;

(2) The proposed duration of the power purchase agreement;

(3) The time for completion of the project;

(4) The quality of the proposed financial plan;

(5) The requested credit support related to the power purchase agreement;

(6) The merits of the technical bid; and

(7) The merits of the legal bid.

In assigning weights to these factors, the net present value of the proposed tariff should be assigned by far the heaviest weight and maybe account for 40–50 per cent of the total. Relatively heavy weights should also be assigned to the financial plan and to the technical bid, while the remaining factors would receive weights of only between five and 10 per cent each. The evaluation factors and their weighting should be disclosed in the instruction to bidders.

## G. BREACH OF THE PROCUREMENT PROCEDURES

UNCITRAL's Legislative Guide, in its Recommendation 36, addresses this issue by an adoption of foreign laws or *renvoi* to national rules, as follows:

> Recommendation 36. Bidders who claim to have suffered, or may suffer, loss or injury due to a breach of duty imposed on the contracting authority by the law may seek review of the contracting authority's acts in accordance with the laws of the host country.

The commentary to this recommendation describes the great variety of judicial and administrative review modalities existing in various countries and points out the importance of speedy rulings on complaints by bidders that the procurement procedure has been breached. It is suggested that review by the procuring entity itself, or possibly by another administrative body such as the hierarchical supervisor of the procuring entity or a body especially mandated to hear such complaints, may be able to act with the requisite alacrity to prevent a wrongful award or procurement contract.

In this connection, reference is made to chapter VI of UNCITRAL's Model Law, where one finds quite detailed rules on such administrative review. Regrettably, it would appear that the rules have been cast with greater attention to legal theory than to practicality, a concern that is especially pronounced for decisions to suspend, or to extend the period of suspension of, the procurement. Moreover, any "act or decision bringing the procurement contract into force" cannot be reversed, but the injured party can be compensated for reasonable cost in bringing the complaint and for loss or injury suffered in connection with the procurement proceedings.[27]

GATT dispute settlement procedures traditionally have involved only governments and provided for a purely legal examination as well as a political scrutiny. Initially, dispute resolution was only possible through diplomatic channels and was merely forward looking, requiring the party, i.e., the government, in breach to bring its measures into conformity with the GPA, but without demanding compensation for the suffered damage.

Moreover, in view of the time required for the settlement proceedings, the procurement contract mostly would have been awarded and performance been completed or under way so that bringing the proceedings into conformity through correction or cancellation would constitute a disproportionate measure due to the social cost involved. This traditional GATT procedure has been preserved in articles XXI and XXII of the GPA, although it has had no major effect on the way governments have practiced procurement. The new GPA from 1994 has added two new

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27 UNCITRAL Model Law, article 54.

measures, however, one of which already has achieved considerable impact on the conduct of government procurement.

Firstly, article XX.1 of the GPA provides for a consultation procedure by requiring each government that is a party to GPA, in case there is a complaint by a bidder that the GPA's rules on procurement have been breached, to encourage the bidder to "seek resolution of its complaint in consultation with the procuring entity". The procuring entity shall "accord timely and impartial consideration . . . in a manner that is not prejudicial to obtaining corrective measures under the challenge system". It is intended that the incipient dispute in this way may be readily resolved in an agreed and therefore appropriate and fair way that adequately safeguards the commercial opportunities of the complaining bidder as well as of the other participants in the proceedings.

Some observers have expressed doubts about the effectiveness of the consultation procedure by arguing that a bidder often may be apprehensive about straining its relationship with the procuring entity — especially before the award decision has been taken — and therefore will prefer to remain silent concerning a perceived breach by the procuring entity.

Secondly, article XX.2 of the GPA requires each party to introduce a challenge mechanism allowing bidders to file a complaint directly against the procuring entity on the ground of alleged violation of the GPA. For this purpose, each party is required to make provision in its national legislation for a procedure open also to foreign, private bidders, under which such challenges can be heard either by a court or by "an impartial and independent review body with no interest in the outcome of the procurement and the members of which are secure from external influence during the term of their appointment".[28]

Detailed requirements are then stated for review bodies, which are not courts, except for those subject to judicial review. The GPA further requires that such national procedures, whether before courts or independent review bodies, shall provide for rapid interim measures to correct breaches of the GPA and to preserve commercial opportunities of the parties to the proceedings, through suspension of the procurement process, or through correction of the process. Naturally, the GPA also requires the court or independent review body challenge procedure to provide for "an assessment and a possibility for a decision on the justification of the challenge" and for correction of the breach of the GPA or compensation for the loss or damage suffered. Compensation may be limited to the costs incurred by tender preparation or the protest.

In view of the foregoing provisions in UNCITRAL's texts and in the GPA, it may be advisable to reassure potential bidders that the rule of law will be observed

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[28] Government Procurement Agreement, article XX.6.

throughout the process, to include provisions in the instructions to bidders that make available and regulate access to third party settlement of claims by bidders that a breach of the applicable procurement procedure has caused them to suffer damage or loss.

While speedy correction of procedure may be obtained by lodging a complaint with the procuring entity itself, this is only relevant prior to the award decision and should not be the only channel open to bidders. Special administrative review panels could be set up with the mandate to review on an urgent basis, to suspend ongoing procurement proceedings, and to order correction of procedure if not commercially disproportionate. In addition, it should be possible to bring compensation claims before an international arbitration body, including claims bottomed on allegations of wrongful award decisions.

# CHAPTER 12
# TOWARDS SUSTAINABLE BUILD OPERATE TRANSFER PROJECTS IN ASIA

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## A. BUILD, OPERATE, TRANSFER IN POST-FINANCIAL CRISIS ASIA

Many Asian governments have adopted the species of infrastructure project finance known as the Build Operate Transfer (BOT) model or variants thereof. The main features of this model consist of a sponsor agreeing to build an infrastructure facility, such as a thermal power plant, toll road, pipeline, harbor, or airport, pursuant to a license granted to it by the government and in exchange for which the sponsor, through a locally incorporated company, the special purpose vehicle (SPV), will manage the facility, derive revenues and, after a period, transfer the ownership of the facility to the government or a state-owned enterprise. Having being introduced to Asia in the 1980s, the BOT model has captured the attention of cash-strapped governments.

Vietnam and The Philippines have enacted detailed laws that cover BOT projects.[1] Other Asian countries have been content to process BOT project identification and selection of the sponsor through their existing frameworks of government procurement.[2] Just as the most-favored-nation concept (now known in the context of China trade as "permanent normal trading relations") was once known mostly to trade lawyers and trade theorists and became well-known in the context of such status being extended to China by the United States, the broad outlines of the BOT concept are now grasped by sections of the community in Asian societies wider than government officials, banks, and businesses.

Various sections of the community, including civil society groups concerned with the massive corruption of their governments, environmentalists, and opposition political parties, have begun to concern themselves with the BOT projects

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[1] "Irani, Infrastructure Projects: the BOT Approach", 8 *Asia B.L.R.* 50 (1995); McMulan, "BOT Projects in East Asia: The Globalising Trends", 27 *Asia B.L.R.* 3 (2000).

[2] Most Asian Commonwealth countries would follow the English Common Law relating to tendering procedures. Craig, *Procurement Law for Construction and Engineering Works and Services* (1999).

proposed or accepted in their countries. The concern is not confined to Asia. Infrastructure projects and privatizations in many countries that wish to become fully market economies have been beset by allegations of rampant corruption.[3] Moreover, what was once discussed in the seclusion of Asian salons among local elites and middle-class professionals can now be disseminated with inflammatory embellishments over the Internet.

At present, the landscape of infrastructure projects in Asia has been blighted by the spectacular misfortunes of two large projects, P.T. Paiton (Paiton) in Indonesia, and the Hub Power Company (Hubco) in Pakistan, where government bodies have repudiated independent power purchasing agreements on the ground that they are fatally tainted with fraud and that the take-or-pay clause incorporating the tariffs has been inflated to accommodate fraudulent kick-backs to local cronies. The predicaments of Paiton and Hubco have sent shockwaves through the investment community and threaten future support of much-needed infrastructure in Asia.

Much of Asia faces a crisis in infrastructure governance. The capital-intensive nature of BOT projects, range of commercial risks, different priorities of the participants, and the sheer size of the topical project make BOT projects unacceptably fragile if they are perceptibly vulnerable to political risk. Despite the complex documentation generated by the teams of blue ribbon lawyers, merchant bankers, and government professionals from both the host country and the exporting countries, the public interest of the host country is rarely a forefront issue that is marketed to the host community as having been satisfied.

That failure seriously de-stabilizes the future of the BOT project. Unless the infrastructure community develops a new paradigm for BOT projects, the fate of Paiton and Hubco will probably be replicated in the future, leading to an increasing cycle of higher tariffs to accommodate a perception of heightened political risk which, in turn, will lead to consumer and other local resistance demanding repudiation of the affected projects. The standoffs generated by this cycle will be detrimental to all the stakeholders, especially the local citizens, who will be the eventual victims of the current paradigm. Accordingly, the interests of all stakeholders require the development of a new paradigm of BOT projects that is directed to sustainability of the project. The high visibility of BOT projects in Asia has pushed into the limelight of public law an area that was once regarded as arcane and the specialty of merchant bankers, constructors, and procurement specialists.

## B. THE STAGGERING COSTS OF BOT PROJECT FAILURE

Even a cursory examination of the Paiton and Hubco cases reveals the staggering financial costs to a variety of stakeholders when a BOT project is repudiated on the ground that it was obtained by fraud or has been budgeted with kickback

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[3] "Latin America's Scourge/Painful Birth of Free Markets: When Price of Reform is High-Profile Graft", *International Herald Tribune*, March 14, 2000, at p. 2.

components. The Paiton project was initiated during the heyday of the commercial diplomacy of the late Mr. Ronald Brown when he was the secretary of commerce. The sponsors were General Electric, Edison Mission Energy, and Mitsui. During the negotiations of this contract, the consultants engaged by the Indonesian government electricity department, PLN, protested as did PLN that Indonesia did not need the project as the country had a surfeit of electricity and that the tariffs were over-priced. They communicated their objections to the United States Exim Bank, which insured the project in the amount of US $450 million. After the fall of President Suharto, PLN repudiated the contract stating that the BOT project was awarded because of the influence of the Suharto family and cronies, and the construction claims had been inflated by US $1 billion. PLN also claimed that the tariff of US $6.60 per kilowatt hour for a 30-year period was almost double the global benchmark. PLN filed an action in Indonesian court to have the entire project canceled on account of fraud.

When this happened, the ratings agency, Moody's, downgraded Indonesian debt by several levels leading to a steep increase in the cost of funds borrowed by Indonesian borrowers generally. The governments of the affected parties also protested to the Indonesian government. The current head of the Indonesian Government, President Wahid, ordered the withdrawal of the action and asked the parties to negotiate a settlement. Considering the background of this project, an editorial in the *Asian Wall Street Journal*, normally pro-business in its orientation, declared "our sympathies are with the Indonesian people. They stand to lose no matter what. If the expensive contracts are honored that will bleed the country for decades. If the contracts are breached, foreign investors may stay away for years. By comparison, the IPP's look much better off. Despite all the carping, you could call theirs a win-win-win situation".[4]

In Hubco, the companies comprising the sponsor were National Power of United Kingdom, Mutsui, and the Xenel Corporation of Saudi Arabia. The World Bank acted both as the guarantor and lender to the project. Forty-three commercial banks participated in providing 15 debt facilities in seven currencies.[5] After the Shariff government came to power, the Water and Power Development Authority of Pakistan (WAPDA) repudiated the contract. When the military overthrew the Shariff government, the new military government did not have WAPDA change its position. Despite the parties having provided for International Chamber of Commerce (ICC) arbitration, the Pakistan Supreme Court restrained Hubco from invoking the arbitration clause. As with Paiton, the Hubco controversy has generated ill will between the host government and foreign governments and donor institutions.

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[4] Editorial, "Take or Pay in Indonesia", *Asian Wall Street Journal*, July 29, 1999, at p. 10.

[5] For details of this project, see Gerrard, *Financing Pakistan's Hub Power Project: A Review of Experience for Future Projects* (The World Bank, 1997).

## C. WHITHER BOT PROJECTS IN ASIA?

Much of Asia, having welcomed the Year of the Golden Dragon, awaits a strong reversal of the downward trend in their economies that comprised the Asian financial crisis. Although commentators believe the Asian financial crisis is over, the less sanguine point out that the deep structural problems that induced the crisis in the first place still remain in place. The reforms suggested by donor institutions for many countries in the Association of South-East Asian Nations (ASEAN) have comprised the enactment of legislative packages on issues such as banking reform, insolvency, and regulations to promote good corporate governance. Others have criticized these reforms as inadequate because the judicial and bureaucratic systems in place are corrupt, under-resourced, and incompetent, and therefore are unable to enforce these reforms and make them meaningful.

To these critics, although much appears to have changed, in fact little has changed, and they argue that the next crisis would be even more ferocious in its effects than the previous crisis. Regardless of the merits of these positions, one thing appears to be clear, and that is that the same elements, such as high-level corruption or widespread perception of high-level corruption that caused the Paiton and Hubco debacles, still remain in place and pose threats to the sustainability of future BOT projects in the region. The magnitude of the problem is illustrated by the admission by a World Bank official that its "own competitive bidding processes had actually been manipulated. We discovered that in this sort of environment we could not even ring a fence around our own operations".[6]

Several factors combine to make privately funded infrastructure through BOT projects in Asia the dominant form of infrastructure development. The number, size, and sustainability of such BOT projects would depend on making these projects sustainable in their host societies and reducing the presently high level of political risk.

Due to fiscal austerities, the cash-strapped governments of industrializing Asia find it difficult to fund capital-intensive projects through their own budgets. Donor institutions that previously provided soft loans for infrastructure have for some time required governments to procure infrastructure on commercial terms from the market. This trend is likely to continue. The report by the United States Congress-appointed International Financial Institutions Advisory Commission — the Meltzer Report issued in March 2000 — faulted the World Bank and the International Monetary Fund (IMF) for providing facilities to countries which the Report argued should be sourced from the market.

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[6] Jean Michel Severino, World Bank's vice president for East Asia, quoted in "Corruption on Rise, Asians are Warned", *International Herald Tribune*, February 13, 2000, 1, at p. 13.

With the drying up of these soft loans, the so-called Y2K5 problem will impose additional pressure for privately funded infrastructure. Unlike its relative, the Y2K computer problem which proved to be a damp squib, the Y2K5 problem threatens to dislocate the lives of millions in Asia. In 2005, the garment quotas that presently exist under the Multi-Fiber Agreement will be dismantled, and there will be a free market in textile production. In other words, garment manufacturers will be able to locate in whatever part of the world they want without having to worry about bumping against a ceiling of quotas that are presently operative. The belief in Asia is that many garment operations will migrate to China and leave workers presently employed in countries such as Sri Lanka, India, Bangladesh, and Indonesia without employment. These factors will put immense pressure on the governments of these countries to create replacement jobs. An important source of such jobs in the past in Asia has been foreign direct investment and, with the aggressive courtship of the investment dollars that is being waged by Asian governments, countries that offer good infrastructure will be in front of the countries with less developed infrastructure in terms of attracting more foreign direct investment.

## D. COOPERATION AMONG STAKEHOLDERS IN REDUCING POLITICAL RISK

Most BOT transactions that are successfully concluded represent a triumph of consensus among the sponsors, lenders, host governments, and other participants who have allocated the diverse range of risks among themselves in a commercially satisfactory manner. Donor institutions such as the World Bank, its affiliate the International Finance Corporation, and home country exim-banks play a constructive role in infrastructure projects in the developing world. In the aftermath of the stricken Paiton and Hubco projects, the political risk of BOT projects in Asia would deter several participants who took part in syndications prior to the financial crisis. The magazine *Euromoney*, e.g., reported that several small banks that were unheard of in the infrastructure community clamored for a share of the pie in syndications prior to the Asian financial crisis.

Furthermore, the margin to compensate for increased political risk will also increase and paradoxically make the BOT project more difficult to justify to host country critics. The Chinese ideogram for crisis is a combination of letters signifying danger as well as opportunity. The present climate for BOT projects in Asia combines these factors — dangers to the project created by host country groups that are sick of their corrupt governments and opportunity for honestly bargained infrastructure expansion that provides more jobs and opportunities. A constructive response by the infrastructure community to the Paiton and Hubco fiascoes is to build a sustainable BOT model that can withstand the inevitable buffeting that such projects will receive in host countries. Such a model must not be a straitjacket but may be flexible to accommodate market realities.

A BOT project that is the result of an arms-length bargaining process is the ideal. However, a project that meets this test is not enough. It must be seen to meet

that test in the host country as well as to offshore participants, foreign governments, and donor institutions. Furthermore, capricious and arbitrary repudiation of BOT projects by irresponsible successor governments must also be deterred. The infrastructure community can work to promote BOT sustainability in three areas:

(1) At the level of the host country by means of existing contractual and tort mechanisms that will induce a fairly bargained contract, and corporate law principles designed for good governance.

(2) At the level of the home countries of the sponsor participants and offshore lenders. These measures will benefit the home countries in that their exim-banks and stock exchanges will be positioned to fund sustainable private sector infrastructure projects. The diplomatic capital of the home countries would not need to be squandered, on behalf of a small but powerful group of their companies, in pressuring host countries to act against the interests of the latter's citizens.

(3) At a multilateral level where the role of donor institutions, non-governmental institutions, and a treaty framework combine to provide a framework that allows market mechanisms to dictate individual BOT projects and exclude distorting factors like host country corruption and cronyism.

It is submitted that such a tripod, comprising host country processes and substantive law, home country supports deterring nationals from subverting good governance in the host country, and donor institution monitoring and involvement can support future BOT projects in Asia that can withstand local attacks and thus reduce the political risk component in project finance. These concerted moves will have the effect of making the due protection of the public interest the central plinth in Asian BOT projects and thus spike the guns of the local lobbies that work to overturn the projects.

Host country governments also will find it easier to defend BOT projects as well as the consumer costs entailed once they are shown to be the products of honest and free bargaining in the international marketplace. Competition for such projects will be enhanced as players, once deterred by the immense costs of developing a bid without the influence of a local strongman, will be encouraged to return to the region.

## E. HOST COUNTRY TRANSPARENCY AND SUBSTANTIVE LAW INCENTIVES

### 1. The Procurement Process

Many foreign sponsors justify their partnering with local strongmen on the ground that it is impossible to push the project forward in developing countries without

strong local influence.[7] This argument is not without merit. Bureaucracies in developing countries are frequently corrupt, obstructionist, and inefficient. A big stick is required to get things moving. At the local level, the sponsors can also encounter opposition and hurdles as the local chieftains attempt to extort their share of the money. Host country governments can address this concern in some creative ways.

Likewise, the infrastructure community consisting of sponsors, merchant banks, law firms, and others could help evolve a template for BOT contracts that could take into account the vital concerns of the sponsor and the citizens of the host countries. For example, this template could include a pre-contractual representation from the sponsor that it will bargain at arm's length with the host government and that it will not unethically influence negotiations by inducing government officials of whatever rank to breach their fiduciary obligations of using state power exclusively for public ends. Due diligence reviews and closing opinions of lawyers must address the issues of the BOT contract having being obtained on terms that are the result of anything less than an arm's-length bargaining process. The sponsor may legitimately use the commercial diplomacy available from the home country as well as accredited local lobbyists and agents. It is only when the sponsor's influence becomes corrupt that the BOT project itself becomes tainted. To meet the concerns of the sponsors that a local strongman is necessary to cut through the bureaucratic red tape and the multiple obstacles encountered in developing Asia, the host government can offer to provide "one-stop" services to the sponsor.

Under this arrangement, the host government would undertake to obtain all the licenses necessary for the sponsor to proceed with the BOT project. A timetable for critical milestones to be completed could be set up and, where the host government defaults in performing its obligations to get licenses and to create conditions on the ground for timely implementation, it should be required to pay liquidated damages to the sponsor. A sponsor that does not wish to start off a project by claiming liquidated damages from the host government should be able to elect to extend the life of the project by a pre-agreed timetable so that the eventual handover of the plant to the government is delayed. The main BOT contract between the host government or off-taker and the sponsor itself will contain an implied warranty that no undue influence was used in obtaining the contract and an implied term allowing a re-adjustment of rates in case that warranty was breached. Breach of this implied term should expose the sponsor, not to the termination of the contract, but to the obligation to re-negotiate on tariffs.

In the *Hubco* case, although the project contemplates resort to arbitration at the ICC in Paris, anti-suit injunctions issued by the Pakistani courts have thwarted resort to this remedy. This Mexican stand-off situation can be avoided if all BOT project disputes between the SPV, the sponsor, and the host government are referred

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[7] Neumann, "Legal Framework for BOOT Project Financing in Emerging Countries" (Paper Presented at Center for International Legal Studies, International Project Finance Conference, January 23–29, 2000).

to the International Center for the Settlement of Investment Disputes (ICSID).[8] It could be provided that the issuance of an anti-suit injunction by a court in the host country automatically triggers an arbitration at ICSID or that anti-suit injunctions will have no force in relation to BOT projects.

The *quid pro quo* for this will be that, where the host government can reasonably show that the sponsor obtained the BOT contract by means of undue influence, the ICSID tribunal will have the right to issue an award on an *ex aqueo et bono* basis,[9] and could thus reduce the tariff by an amount that conforms with market rates. This would be a powerful incentive for the sponsor to ensure that, however hard the bargain that it drives, the contract it secured complied with the same levels of honesty as a contract that would be awarded by a country like the United States, using its own procurement standards. At the same time, these factors provide the host government with the justification to explain to its own constituencies why it will honor the BOT contract. Frivolous and vexatious delaying tactics, whether used by the government itself or by citizen groups, could thus be reduced.

## 2. Deterring SPV Misconduct through Host Country Corporate Law

The SPV, being a company organized under the laws of the host country, is subject to the corporate law of that country. The corporate laws of many Asian countries comprise of doctrines that could be used to restrain overreaching sponsors and their local partners. Under English Common Law, certain principles of company law have been inherited by commonwealth countries such as Pakistan, India, Singapore, and Malaysia. In addition, statutory changes to the various companies' legislation provide a platform from which sponsor misbehavior can be checked. For example, in the Common Law relating to promoters' liability, a promoter is required to disclose, fully and frankly, all benefits derived from selling assets to the company, and this disclosure should be made to an independent board, absent which, to the shareholders of the company.

These principles are flexible in their sweep and can include onerous sole source contracts that are concluded with local elites as well as the licenses that are obtained by the SPV pursuant to the influence of the local partner in exchange for free-carried interests. In neither of these cases is there an actual sale of assets by the promoter to the company, but where someone is promoting a company, and procures benefits conferred by a third party in exchange for gains in the company, it is arguable that full disclosure to an independent board must be obtained. In a globalized economy, the law of promoters cannot restrict itself to tangible assets and intangible assets such as the recognized forms of intellectual property. It should seek to include economically significant benefits for which there is a *quid pro quo*.

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8 575 UNTS 159, 17 UST 1270.

9 Such contractual authority should be sufficient for the purposes of article 42(3), which allows the tribunal to decide a dispute *ex aequo et bono* if the parties so agree.

Not infrequently, the shareholders of the SPV initially include the off-taker or a host government agency or a host government bank.

Later, if the SPV becomes listed, the public of the host country also become shareholders.[10] Here, two sets of principles, the English Common Law relating to directors' duties and the Common Law and statutory support for derivative actions, can be used to check director misconduct. The Common Law, as applied in most ex-British colonies in Asia, is clear in that the directors owe duties to the company and not to the appointing shareholders. In the SPV, directors must be held to that standard of conduct so that they do not do the bidding of the sponsor shareholder but promote the interests of the company itself, which may sometimes be at variance with the interests of the sponsor.

Arguably, the directors should not ratify pre-incorporation contracts such as non-competed feedstock contracts from local cronies at inflated levels. When directors ratify these contracts, manifestly unfavorable to the SPV and at the behest of powerful shareholders, then the principles relating to derivative actions would provide a justification for minority shareholders to bring an action against the directors. As an example in a commonwealth jurisdiction, section 216A of the Singapore Companies Act allows a shareholder, or even an interested party, of an unlisted company to bring an action on behalf of the company after exhausting internal complaint mechanisms. Article 85(3) of the Indonesian Company Law allows any shareholder representing 10 per cent of the total share capital of the company to bring a derivative action against directors who have caused loss to the company even where due to mistake or negligence.[11]

The issue of directors' duties is of course intimately connected with the larger topic of corporate governance. Inadequate corporate governance has been highlighted as one of the major factors that led to the financial debacle in Asia. The SPV could be required to participate in the reforms relating to corporate governance, such as having independent directors and an independent audit committee. Given the prominent role that SPVs can be expected to play in Asian societies, host governments could encourage SPVs to include representatives of civil society groups as outside directors to increase the credibility of the SPV as a good corporate citizen.

Finally, when the SPV is listed on the local exchanges, the prospectus regulations should be clarified to require greater disclosure of factors that relate to the sustainability of the project. For example, section 55(1) of the Singapore Companies Act allows persons who subscribed for any shares or debentures on the faith of the prospectus to sue a broad category of persons, including directors, "for any loss or damage sustained by reason of the willful non-disclosure of any matter of

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[10] See The Hub Power Company prospectus, whereby 69,284.075 new ordinary shares were issued at Rs 10 each (1994).

[11] Tabalujan, *Indonesian Company Law* (1997), at pp. 192 and 193.

which he had knowledge and which he knew to be material". If the BOT project is likely to be repudiated on the ground that it was obtained by fraud or corrupt means, and there is evidence that could be used to justify that repudiation, then failure to disclose these factors in a prospectus should be a ground for relief to affected shareholders or debenture holders.

In many countries, the SPV has been regarded as a *sui generis* form of corporate entity, immunized against the vagaries of host country corporate law by means of a *cordon sanitaire*. While this is true to some extent, there is no reason to exempt SPVs any longer from the restraints imposed by the host country corporate law. A public perception in the host country that the SPV integrates sound corporate governance mechanisms can promote the sustainability of the BOT project. Likewise, if the shares of the SPV are listed on the local exchange with the understanding that all material facts will be fully disclosed, then the broad-based public ownership will in turn create pressures for sustainability.

### 3. Host Country Reforms

In most Common Law countries, it is an axiom of constitutional law that the right to tax must be founded on a law. In Commonwealth countries that have bicameral legislatures, a convention derived from the Westminster model of democracy requires that money bills originate in the lower chamber, i.e., the chamber that has widespread popular representation. Where a BOT project involves the supply of popular services, e.g., electricity, water, gas, or toll roads, to the consumers, the ultimate payor of such services is the citizen. By entering into an off-take agreement, the government in fact acts as the agent of the SPV to exact tolls from its citizens. Given the resemblance to taxation, it is arguable that governments should seek approval of BOT projects in parliament before they are signed.

It is not suggested that they should be the subject of full-dress debate, but the main contract should be tabled before parliament. There are several advantages to this process. Firstly, the transparency involved will deter many governments from tabling egregiously corrupt transactions for approval. Most governments in Asia are widely distrusted by their citizens. In Thailand, for instance, one previous government was derisively known as the "Buffet Cabinet",[12] in that various projects could be picked and chosen by ministers for enrichment of themselves, their families, and cronies. Often, the legislature is controlled by the government in power, but the very act of tabling the contract will allow the opposition parties to comment on the unusual features of the transaction. Secondly, the process has a sanitizing effect.

It will indeed be difficult for a subsequent government, non-governmental group, or other interested party to overturn a BOT project that has been tabled

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[12] The Chart Thai government that was overthrown in a bloodless coup in 1991. See "Chart Thai-led Coalition Faces Bumpy Ride", *Business Times* (Singapore), July 4, 1995.

before the host country parliament and which has, in effect, being ratified by the contract. The sponsors could legitimately argue that the people's representatives having put their seal of approval on the BOT project, its legitimacy cannot be plausibly contested thereafter. Finally, such legislative procedures will build a culture of accountability among many governments that hitherto have pledged their countries' treasuries for multibillion dollar projects that either have little public benefit or which incorporated hundreds of millions of dollars of kickbacks for relations and cronies of the local strongman.

Host countries in Asia also may need to strengthen their regulatory institutions that have oversight functions over utilities to ensure that the public interest is factored into decision-making. Unfortunately, much of Asia lacks a workable culture of utility regulation that depends on trained regulators, a functioning system of administrative law, economists, and others, for its success.[13]

## F. HOME COUNTRY MEASURES

With the cold war a thing of the past, many Organization of Economic Cooperation and Development (OECD) governments regularly engage in aggressive commercial diplomacy. A trip by presidents and prime ministers from OECD countries to the developing countries in Asia is not considered a success unless deals worth billions of dollars are signed in ceremonies before TV cameras that beam back the message of successful government back to the electorates in home countries. Quite often, the bankability of the project, the costs of the environment, and the sleazy private alliances that have made the deals possible are ignored.

The reality for the home country when things go sour can be a heavy price paid by the governments and the taxpayers. When a contract is repudiated, the sponsors are not averse to invoking diplomatic pressures from their home governments on the host government to honor the contracts. The diplomatic machinery is then set in gear to repeat the mantra, "the contract is a contract", and the refrain about sanctity of international contracts is taken up without considering the injury caused to hapless local populations betrayed by unrepresentative governments and exploited by unscrupulous sponsors.

The screws could be tightened because the sponsor may have sometimes obtained political risk insurance from government agencies in the home country and can call on that insurance. These home country government insurance agencies, such as the Overseas Private Insurance Corporation (OPIC), are then subrogated to the claims of their nationals, and can make legitimate demands on the host government. Indeed, in the Paiton case, the United States OPIC is exposed to US $400 million in claims and, under an agreement made with the Government of Indonesia, it can

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[13] Asian Development Bank Report, *Governance and Regulatory Regimes for Private Sector Infrastructure Development* (prepared by National Economic Research Associates, 1998).

claim this amount directly from the Government of Indonesia. Some segments of the American population might well wonder what their government is doing twisting the arms of a government of an impoverished people to pay for services that were not needed in the first place and were the outcomes of a particularly aggressive phase of commercial diplomacy.

Indonesia is of vast strategic interest for the United States. It is arguable that the United States should not squander its diplomatic capital to protect the interests of a few companies. On the other hand, if the United States does not do this, it sends an ambiguous signal to other countries about the consequences of molesting foreign investment.

Furthermore, the taxpayer who funds governmental institutions like OPIC bears the brunt of these ill-conceived commercial diplomatic offensives. In the aftermath of the *Paiton* disaster, there are many prophylactic measures that the United States and other OECD countries could take to prevent a repeat of these BOT project crashes.

First, home country legislation should be amended to address an egregious species of overseas bribery that is not presently covered by the OECD Bribery Convention and the United States Foreign Corrupt Practices Act. The gap relates to transactions where the home country company associates formally or indirectly with a host country elite to win the contract, and it can be shown that the local elite corruptly influenced the selection of the sponsor in return for a share of the venture. In most cases, the local partner is a crony capitalist who is either related to the president or a powerful political figure or is connected with a favored business entity that either acts as the bagman for the president or provides funding for political parties.

The reward that is given by the foreign sponsor may be outright commissions or disguised in the form of free shares, known as free carried interests, or various unfavorable contracts entered into with the local party's groups of companies, or a combination of all of the foregoing. At present, the offshore bribery laws do not cover this form of offshore bribery presumably because it is difficult to draw bright line rules that differentiate associating with powerful local partners for strategic reasons and associating for the substantial purpose of obtaining a capital-intensive project using an influence peddler. Foreign companies can circumvent injunctions against offshore commercial bribery by selecting as their joint venture partner an influential person who manages to win such bids. So long as this loophole remains, it will be exploited with deleterious consequences for the integrity and efficiency of the project.

Second, insurance and funding agencies like OPIC and the Eximbanks should integrate factors such as cronyism and local patronage into their due diligence reviews. The home country taxpayers have an interest in not supporting companies that have obtained BOT contracts that are susceptible to being overturned on grounds of corruption or nepotism. Companies that seek insurance from home government organizations such as OPIC should be required, just like other insured

subject to the *uberrimae fides* rules, to make a full disclosure of all factors that could lead to the awarded BOT contract being subsequently repudiated by the host government. Failure to disclose such factors, when negligent or deliberate, should be a ground for avoiding the insurance. Finally, the results of due diligence should be open for disclosure under the Freedom of Information Act.

Professor Cynthia Williams has argued in the *Harvard Law Review* that the United States Securities Exchange Commission has the authority to require disclosure by listed companies of certain social factors that influence investment decisions.[14] The shares of the HUB Power Company were listed both within Pakistan as well as in Luxembourg. Where one of the participants of the sponsor company is the subsidiary or parent of a company listed on a United States exchange, it could be required that such companies fully disclose the details of the local partner and the contracts that they have entered into with the local partner so that investors will have access to these facts.

With the pace of globalization accelerating, the proposal of Professor Williams needs to be considered seriously not only by the United States Stock Exchange Commission but also by stock exchange authorities that wish to promote transparency and full disclosure. The Busang gold mine scam, where the richest gold mine was reputedly found in Kalimantan, Indonesia, and the speculative frenzy that attended the listing in the Vancouver exchange is an object lesson to regulators on the dangers of listing companies based on projects in developing countries that do not have a strong local regulatory culture.

## G. MULTILATERAL COMPONENTS SUPPORTING SUSTAINABLE BOT PROJECTS

The Industrial Standards Organization has released criteria, satisfaction of which results in credentials that are of commercial value. The granting of these credentials and the constant checks that monitor compliance with the standards by the affected organizations provide credibility to many businesses in Asia and elsewhere. Various participants, including the accounting firm of KPMG-Peat Marwick, helped establish Social Accountability standards, the SA8000,[15] which address standards in the workplace.

Given the importance of infrastructure, a similar set of standards could be formulated with BOT projects. These standards could address the issues of transparency, arms-length contracting, environmental standards, and criteria of honesty derived from the Foreign Corrupt Practices Act and the OECD Bribery Convention. A certifying

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[14] Williams, "The Securities and Exchange Commission and Corporate Social Transparency", 112 *Harvard Law Review* 1199 (1999).

[15] Issued by the Council of Economic Priorities Accreditation Agency.

authority would consist of a range of stakeholder interests including representatives of constructors and sponsors, banks, donor institutions, and non-governmental organizations.

Relief at ICSID and from the Multilateral Investment Guarantee Agreement (MIGA) could be conditioned on the plaintiff-sponsor not having obtained the contract by corrupt means in the first place. Affected citizen groups, such as non-governmental organizations based in the host country, should be able to file briefs in any proceeding brought by the sponsors. Because corruption and fraud are difficult to prove absent a range of discovery and investigative mechanisms that are not practical, the sponsor must be faced with certain presumptions that could be rebutted.

These would be that the existence of a politically powerful local partner coupled with a tariff rate or supply contracts that appear to be abnormally priced give rise to the presumption that the BOT contract license was obtained by fraud in the first place. Other factors that could give rise to a presumption are if the local partner is given a "free-carried interest" by virtue of a license that he has brought into the project; it is found that the local government instrumentality that would be responsible for the off-take had protested and so had their consultants; and if there are sole-source supplies of feedstock contracts entered into with the local partner.

It is anyone's guess whether the draft Multilateral Agreement on Investment (MAI) proposed by the OECD will garner sufficient consensus to become an international treaty. The MAI envisages corporations instituting actions against sovereign states. It is deafeningly silent about the rights of local populations who have been the targets of corporate predation by reason of corrupt transactions between the host country government and such corporations. To restore some balance, the draft MAI could establish a code of corporate good conduct with regard to operations in host countries, and also provide standing to various non-governmental groups to bring actions against corporations in their home states in respect of transactions corruptly concluded in the host country.

The Common Law, at least, is rich in theoretical justification, one of which would be inducing an agent (a government or minister) to breach fiduciary obligations owed to the state and its people, for such causes of action to be developed. To ensure that the floodgates remain shut, the non-governmental organization plaintiff could be required to obtain a certificate from a governmental authority, such as the justice department of the home state, that would monitor such actions and weed out frivolous actions.

## H. CONCLUSIONS

The project finance community comprises many creative individuals representing a diverse range of interests. Despite interests that are often adversarial, these individuals manage to establish massive projects that are based on such fragile fundamentals as creditworthiness and perceptions of political risk. Through scores of

interlocking agreements, these professionals manage to create the equivalent of a-billion-dollar Calder mobile by calibrating risks of the participants in agreements that, amazingly enough, are acceptable to all of these participants.

The post-financial crisis challenge to the project finance community working in Asia is to take time off from its narrow technical specialties and look at the broader picture in which an Asia is receptive to many more infrastructure projects provided they can be sustained. If the community can devote its creative energies to forging a new paradigm, then there will be more projects with vibrant spin-offs of economic activity and more work for project finance professionals. Failure to address this problem may result in the crash of the BOT model that would defeat the best efforts of all the king's horses and all the king's men to revive a form of project finance that is highly discredited among restive populations in many Asian states.

CHAPTER 13

# SECURING UNITED STATES ASSETS ON MULTINATIONAL PROJECTS

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## A. INTRODUCTION

In today's international economy, a large commercial venture can involve numerous parties from many different nationalities. A single, large construction project in one country can involve banks, engineers, architects, contractors, specialty contractors, and manufacturers from a number of different nations. Completing a major construction project can encompass numerous contracts between parties of many different countries. The disputes between the parties involved with such projects can involve proceedings in several different forums. In many instances, a dispute will enter the judicial system of the United States.

The following chapter will discuss issues impacting on the enforcement and resolution of international disputes which have some nexus to the United States.[1]

The topics are not independent but are interlinked as issues discussed within one topic can extend and be relevant to another topic. For example, the information within the section on "Proceedings within the United States Which Are Based on Foreign Transactions", would be helpful to a party attempting to enforce a judgment within the United States.

It is the intent of the following chapter to shed some light on many of the issues encountered by the international litigant entering the United States judicial system, and to provide some information regarding traditional methods to insure payment under United States laws and procedures.

[1] In this chapter, the term "foreign" shall be based on a United States' perspective.

## B. PROCEEDINGS WITHIN THE UNITED STATES WHICH ARE BASED ON FOREIGN TRANSACTIONS

### 1. In General

Generally, the first step towards initiating a proceeding in the United States begins with the filing of a complaint. However, the court cannot decide on the matter until it obtains jurisdiction over the defendant. In the United States, jurisdiction is based on the defendant, and the state in which the complaint is filed must have some connection with the defendant to obtain jurisdiction.

Examples of connections that a defendant may have with a particular state which would invoke the jurisdiction of the courts within that state include: a residence, principal place of business within a particular state, an act of transacting business within a particular state, the commission of a tortious act within a particular state, or the execution or performance of a contract substantially connected with a particular state. To invoke the jurisdiction of the court, the defendant must be given notice of the pending action by service of the complaint and summons.[2]

In the United States, there are generally two separate judicial systems, i.e., a federal and a state system. The federal courts are courts of limited jurisdiction which have subject matter jurisdiction over matters conferred by the United States Constitution or by federal statute. All other matters are left to the individual state courts. Most commercial disputes are based on contractual issues and do not involve federal issues. Examples of commercial matters which are based on federal law include: arbitration, foreign sovereigns, antitrust, copyright, patents, securities, and bankruptcy.

### 2. Diversity Jurisdiction

Even though a particular proceeding does not involve federal issues, the litigants in many cases have the option of obtaining federal diversity jurisdiction. If all of the plaintiffs are from states or nations that differ from the states and nations in which the defendants are domiciled, and if the amount in controversy exceeds a certain jurisdictional amount, then a party can decide to litigate a matter in the United States District Court rather than in a state court. If the federal forum is selected, the Federal Court will follow federal procedural law which might provide several advantages to the resolution of an international dispute, e.g., Federal Rules of Procedure have special rules which govern service on individuals in a foreign country.[3] The federal rules of procedure allow the court to consider any relevant material

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[2] There are a number of different methods to obtain service on an individual or corporation including, but not limited to, service by a sheriff, service by a special process server, service on the secretary of state, and service by publication.

[3] Federal Rules of Civil Procedure, rule 4(f).

or source in the determination of foreign law.[4] The area from which the pool of jurors is selected in a federal court will also generally be greater than the area from which jurors are selected by a local state court.

In a diversity action, the federal district court will apply the substantive laws, including the choice of law rules of the forum state in which it resides.[5] In some situations, a corporate defendant may be amenable to service in several jurisdictions. In that event, a party should consider the differences between the substantive laws of the states in which jurisdiction can be obtained before filing suit. In the event that the chosen venue does not have personal jurisdiction over a defendant, the defendant must be careful not to waive the jurisdictional defense by filing an appearance and proceeding with the merits of the case.

Once a judgment has been obtained, the plaintiff can execute the enforcement of the judgment through the use of liens and garnishment proceedings to obtain payment. If the assets of the defendant are not within the state in which the judgment was originally entered, the plaintiff may decide to register the judgment in another state. A state will generally allow recognition and enforcement of the judgment from another state pursuant to the Full Faith and Credit Doctrine which is based on the United States Constitution.

Even if the court obtains jurisdiction over the parties, the suit can still be dismissed if the venue is not convenient to the dispute. The doctrine of *forum non conveniens* is based on the courts' inherent power to control the parties and cases before it and to prevent its process from becoming an instrument of abuse and injustice. Through this power, a federal court may decline to exercise its jurisdiction even though the court has jurisdiction and venue, where it appears that the convenience of the parties and the court and the interests of justice indicate that the action should be tried in another forum. A three-prong test has been developed to weigh the private interest factors and the public interest factors in determination of whether a court should dismiss an action, is based on *forum non conveniens*. The test includes the following factors:

(1) Is there an available and adequate alternative forum;

(2) If so, do the relevant factors of private interest mandate dismissal; and

(3) Do relevant factors of public interest mandate dismissal.[6]

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[4] Federal Rules of Civil Procedure, rule 44.1.

[5] Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487, 496 (1941); see Louis Perez v. Alcoa Fujikura, Ltd., 969 F.Supp. 991, 1003 (W.D. Tex. 1997) which applied the rule expressed in *Klaxon* to an international dispute between parties from Mexico and Texas.

[6] Neo Sack Ltd. v. Vinmar Impex, Inc., 810 F.Supp. 829, 832 (S.D. Texas 1993).

### 3. Relevant Factors

The determination of whether the relevant factors of private interest mandate dismissal includes an analysis of several factors, including:

(1) The relative ease of access to sources of proof;

(2) The availability of a compulsory process for obtaining the attendance of unwilling, and the cost of obtaining the attendance of willing witnesses;

(3) The possibility of viewing the premises, if viewing would be appropriate to the action; and

(4) All other practical problems that make trial of a case easy, expeditious, and inexpensive.[7]

For example, the case *Neo Sack* involved an action commenced by an Indian corporation against a Texas corporation in the Federal District Court of Texas. The Texas corporation moved for dismissal based on *forum non conveniens* grounds. In granting a dismissal, the court determined that there was a remedy available to the plaintiff in India and that India's legal system compared favorably with that of the United States.

The court also determined that while the Indian plaintiff chose the United States forum to resolve the dispute, a foreign plaintiff's selection of a United States forum is given less deference than a United States citizen's selection of his home forum. The court determined that almost all of the witnesses resided in India. The court also determined that most of the witnesses spoke their own language rather than English and that most of the relevant documents were in that language. Finally, the court determined that Indian law would apply, which would be more easily interpreted by an Indian court.[8]

### 4. International Proceedings

In many cases, an international proceeding will involve a nationalized corporation or a foreign government. Litigation between United States parties and foreign sovereign parties is governed by the Foreign Sovereign Immunities Act (FSIA).[9] The immunity of a foreign country from the jurisdiction of the courts in another country has historically been an undisputed principle of international law. As governments increasingly engaged in international commerce, the limitations imposed by sovereign immunity created an unfair advantage to foreign governments which were competing in private commercial activities.

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[7] Neo Sack Ltd. v. Vinmar Impex, Inc., 810 F.Supp., at pp. 834 and 835.

[8] Neo Sack Ltd. v. Vinmar Impex, Inc., 810 F.Supp., at pp. 834–840.

[9] 28 United States Code, section 1330.

Under the FSIA, foreign states are immune from the jurisdiction of the United States courts unless the commercial activity falls within one of the exceptions set forth within the Act. The exceptions include:

(1) An explicit or implicit waiver by a foreign state;

(2) A commercial activity carried on in the United States, an act performed in the United States in connection with a commercial activity elsewhere, or an act in connection with a commercial activity of a foreign state elsewhere that causes a direct effect in the United States;

(3) Property taken in violation of international law is at issue;

(4) Rights in property in the United States are acquired by succession or gift, or if rights in immovable property situated in the United States are at issue;

(5) If damages, in a monetary value, are sought against a foreign state for personal injury, death, or damage to or loss of property, occurring in the United States and caused by the tortious act or omission of a foreign state;

(6) If an action is brought to enforce an agreement with or for the benefit of a private party to submit to arbitration;

(7) If damages, in a monetary value, are sought against a foreign state for personal injury or death that was caused by an act of torture, extra-judicial killing, aircraft sabotage, or hostage taking, or the provision of material support, or resources for such an act, if the foreign state is designated as a state sponsor of terrorism under section 6(j) of the Export Administration Act 1979 or section 620A of the Foreign Assistance Act 1961; and

(8) A suit in admiralty is brought to enforce a maritime lien against a vessel or cargo of the foreign state which maritime lien is based on a commercial activity of the foreign state.[10]

In addition, the foreign state will not be immune from any counterclaim to an action brought by the foreign state or in which it intervenes. However, the foreign state will be immune to the extent that the counterclaim exceeds or is a different kind from the relief originally sought by the foreign state.[11]

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[10] 28 United States Code, section 1605.

[11] 28 United States Code, section 1607.

The FSIA encompasses foreign states as well as political subdivisions, agencies, and instrumentalities of foreign states. An agency or instrumentality of a foreign state is defined as an entity:

(1) Which is a separate legal person, corporate, or otherwise;

(2) Which is an organ of a foreign state or political subdivision thereof, or a majority of whose shares or other ownership interest is owned by a foreign state or political subdivision thereof; and

(3) Which is neither a citizen of the state of the United States as defined in section 1332(c) and (d) of the United Sates Code, or created under the laws of any third country or an instrumentality of a foreign state includes a corporation, association, or other judicial person a majority of whose shares or ownership interests are owned by the state, even when organized for profit.

Federal District Courts have original jurisdiction of claims involving foreign sovereigns.[12] The FSIA sets forth the method of service on foreign sovereigns. If the defendant is a foreign state, the plaintiff may serve the defendant:

(1) By a special agreement between the plaintiff and the foreign state;

(2) As prescribed in an applicable international agreement;

(3) Via mail from the court clerk to the head of the foreign state's Ministry of Foreign Affairs; or

(4) Via a diplomatic channel.

Once the foreign state has been served, it has 60 days in which to file an answer or other responsive pleading.

## C. ENFORCEMENT OF FOREIGN JUDGMENTS WITHIN THE UNITED STATES

### 1. Forum Selection

In many commercial disputes, the terms and conditions of the contract may have a forum selection provision governing the location for adjudication of any disputes. In an attempt to limit litigation and maintain an equal playing field, the parties may agree on a forum which is equally inconvenient to all concerned. In the event that a judgment is rendered against a United States entity in a forum outside of the United States, the prevailing party may have little leverage to collect on the judgment outside of the United States. It is much more likely that the assets of the

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[12] 28 United States Code, section 1330(a).

judgment debtor can be found and secured within the United States. Therefore, to collect on the judgment, the creditor must seek recognition and enforcement of the judgment within the United States.

Generally, recognition and enforcement of judgments from foreign proceedings are governed by the law of the state where enforcement is sought. However, a state can only recognize a foreign judgment to the extent that the underlying proceedings did not violate due process requirements of the United States Constitution. Due process requires that the defendant have a minimum contact with the underlying proceeding. The United States ideals of fair play and substantial justice require the United States defendant to have had some relationship with the foreign jurisdiction in which the original judgment was obtained for it to have reasonably submitted itself to the personal jurisdiction of the foreign court.

For example, in one case a corporation from the Netherlands contracted with a corporation from the United States. After several letters, representatives from the two corporations met and executed a contract in Milan, Italy. In accordance with its contract, The Netherlands-based company manufactured and shipped goods to the defendant from its factory in Switzerland. A dispute arose and the Netherlands company brought an action against the United States defendant in the Netherlands. The Netherlands company obtained a judgment against the United States company in the Netherlands and then sought recognition and enforcement of that judgment in the United States.

On appeal, the United States court decided that the Netherlands lacked sufficient contacts with the United States defendant to meet the Constitutional due process requirements. The court determined that the only contacts that the United States defendant had with the Netherlands were several letters and one phone call between the defendant and the plaintiff in the Netherlands. The contract was executed in Italy and performed in Switzerland. The court decided that the phone call and letters did not establish sufficient contacts between the defendant and the Netherlands to allow a Netherlands court personal jurisdiction over the defendant.[13]

In addition to the requirement that the United States defendant must have minimum contact to allow the forum jurisdiction, due process also requires that the defendant receive timely notice of the proceeding to allow it a reasonable opportunity to defend itself. It has been held that a default judgment in a country which has no statute requiring service on the defendant cannot be enforced in United States courts.[14]

Once the plaintiff establishes that the foreign proceeding complied with United States due process requirements, it must establish jurisdiction over the defendant

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[13] Koster v. Automark Industries, Inc., 640 F.2d 77, 80 (7th Cir. 1981).

[14] Koster v. Automark Industries, Inc., 640 F.2d 77, 80 (7th Cir. 1981), at p. 81.

within the United States. Personal jurisdiction within the United States is based on the location of the defendant. Therefore, to enforce most commercial judgments in the United States, the plaintiff will choose the forum where the defendant is headquartered or otherwise amenable to personal jurisdiction.

Most states within the United States have adopted the Uniform Foreign Money Judgment Recognition Act (UFMJRA).[15] Under the UFMJRA, a state enforces a conclusive judgment from a foreign country to the same extent that a state would enforce a judgment from a neighboring state. For the judgment to be conclusive, it must have been rendered under a system which provides impartial tribunals and procedures which comply with the United States due process ideals of fair play and substantial justice. The foreign court must also have had both personal and subject matter jurisdiction over the defendant.

The UFMJRA does not require the procedures of the foreign court to be identical to the procedures employed by United States courts. A mere difference in the procedural system of a foreign court is not a sufficient basis for non-recognition of a foreign judgment. The procedural deficiency must involve a serious injustice.[16] The fact that a foreign proceeding permits testimony that is not under oath and not subject to cross examination does not in itself provide a basis to deny enforcement of a foreign judgment.[17]

According to the UFMJRA, the original court had sufficient personal jurisdiction if:

(1) The defendant was personally in the foreign state;

(2) The defendant voluntarily appeared in the proceedings other than for the purpose of protecting property seized or threatened with seizure in the proceedings, or of contesting the jurisdiction of the court over him;

(3) The defendant prior to the commencement of the proceedings had agreed to submit to the jurisdiction of the foreign court with respect to the subject matter involved;

(4) The defendant was domiciled in the foreign state when the proceedings were instituted or, being a corporation, had its principal place of business and had acquired corporate status in the foreign state; and

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[15] Compare, in California the UFMJRA is codified at CA. CIV. PRO. 1713.3.

[16] Ingersoll Milling Machine Company v. Granger, 833 F.2d 680, 687 (7th Cir. 1987).

[17] See Ingersoll Milling Machine Company v. Granger, 833 F.2d 680, 687 (7th Cir. 1987), which discusses the intent of the drafters of the UFMJRA to embody the rule stated by the United States Supreme Court in Hilton v. Guyot, 159 U.S. 113, 205 (1895).

(5) The defendant had a business office in the foreign state and the proceedings were based on business transacted at that office.

If the foreign judgment is conclusive, the United States court may deny recognition based on any of the following defenses:

(1) The defendant did not have reasonable notice of the original proceeding in sufficient time for him to defend the original claim;

(2) The original judgment was obtained by fraud;

(3) The cause of action on which the judgment is based is repugnant to the public policy of the state where recognition is sought;[18]

(4) The judgment conflicts with another final and conclusive judgment;

(5) The proceeding in the foreign court was contrary to an agreement between the parties under which the dispute in question was to be settled; and

(6) In the case of jurisdiction based only on personal service, the foreign court was a seriously inconvenient forum for the trial of the action.

### 2. Act of State Doctrine

A related but separate issue, which can affect litigation against a foreign government, is the Act of State Doctrine (ASD). The ASD is the judiciary's institutional response to the foreign relation tensions that can be generated when a United States court appears to sit in judgment on a foreign state's regulation of its internal affairs. Under this doctrine, the courts of the United States will refrain from judging the validity of a foreign state's governmental acts in regard to matters within that country's borders.

The core concern of modern ASD jurisprudence is to preserve the separation of powers between the federal judiciary and the political branches of the government, particularly to preserve the separation of powers of the executive branch which has the responsibility of conducting foreign affairs. The ASD expresses the strong sense of the judicial branch that its engagement in the task of passing on the validity of

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[18] Enforcement of a foreign court judgment based on the law of the foreign jurisdiction, does not offend the public policy of the forum simply because the body of the foreign law on which the judgment is based is different from the law of the forum. See Toronto-Dominion Bank v. Hall, 367 F.Supp. 1009, 1016 (E.D. Ark. 1973). For example, an English judgment which awarded prejudgment interest was enforced in Texas even though Texas law precludes recovery of prejudgment interest, Hunt v. BP Exploration Co., 492 F.Supp. 885, 900–901 (N.D. Texas 1980). An English judgment awarding attorney's fees was enforced in Pennsylvania even though Pennsylvania law precludes the award of counsel's fees, see Somportex Ltd. v. Philadelphia Chewing Gum Corp., 318 F.Supp. 161, 168–169 (E.D.Pa. 1970).

foreign acts of state may hinder rather than further the United State's pursuit of goals for itself and for the community of nations as a whole.

The application of the ASD may cause individual litigants to forego decisions on the merits of their claims because involvement by the courts in such a decision might frustrate the conduct of the nation's foreign policy. For that reason the United States Supreme Court has not created rigid rules to govern the application of the ASD, but instead requires the lower courts to determine whether a conflict between the judicial and political branches exists on a case-by-case basis.[19]

## D. ENFORCEMENT OF INTERNATIONAL ARBITRATION AWARDS WITHIN THE UNITED STATES

### 1. Arbitration Proceedings

The use of arbitration proceedings has become a popular alternative to judicial proceedings for the resolution of disputes arising out of international commercial contracts. Arbitration can provide a level of control and flexibility that the contracting parties would not have in a judicial proceeding. The parties have the opportunity to select the arbitration panel and to limit discovery. The parties also have the ability to agree to a mutually acceptable forum without the stringent due process concerns that impact the enforcement of a judgment.[20]

The United States Arbitration Act (USAA)[21] was designed to allow parties to avoid the costliness and delays of litigation and to place arbitration agreements on the same footing as other contracts. The act provides that an arbitration agreement shall be valid, irrevocable, and enforceable, save on such grounds that exist at law or equity for the revocation of any contract. The USAA also provides for a stay in the proceedings in a case where a court is satisfied that the issue before it is arbitrable under the agreement, and orders a federal court to order parties to proceed to arbitration if there has been a failure, neglect, or refusal of any party to honor an agreement to arbitrate.[22]

### 2. Convention on the Recognition and Enforcement of Foreign Arbitral Awards

The United States, like numerous other countries, has adopted the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, otherwise known as the New York Convention. In the United States the New York Convention (Convention) is codified at 9 United States Code, section 2/204. The United States has

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[19] Environmental Tectonics v. W.S. Kirkpatrick, Inc. et al., 847 F.2d 1052, 1058 (3rd Cir. 1988).

[20] Forum selection provision within the arbitration agreement will be enforced regardless of the contracts between the forum and the parties.

[21] 9 United States Code 1 *et seq.*

[22] Scherk v. Alberto-Culver Co., 417 U.S. 506, 510–511 (1974).

also more recently adopted the Inter-American Convention on International Commercial Arbitration which is codified in 9 United States Code 301 *et seq.*

Under the Convention, the United States recognizes agreements in writing under which the parties undertake to submit to arbitration all or any differences which have arisen or which may arise between a defined legal relationship, whether contractual or not, concerning a subject matter capable of settlement by arbitration.

The Convention applies to the recognition and enforcement of arbitration awards arising out of a commercial transaction or agreement. The Convention does not apply to agreements which are entirely between citizens of the United States unless the agreement has some relationship to a foreign state. The United States District Courts are the courts of original jurisdiction under the Convention. Therefore, the application to enforce the arbitration award should be filed in the United States District Court in the jurisdiction of the defendant.[23] Pursuant to the Convention, the venue is any court in which, except for the arbitration proceeding, a dispute between the parties could have been brought, or in the court designated as the place of arbitration within the agreement, if that court is located within the United States.

The Convention sets forth several defenses to recognition and enforcement of arbitration awards, including:

(1) The defendant was under some incapacity, or the agreement is not valid under the law in which the parties have subjected it or, failing any indication thereon, under the law of the country where the award was made;

(2) The party against whom the award is invoked was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings, or was otherwise unable to present his case;

(3) The award deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration, provided that the decisions on matters submitted to arbitration can be recognized and enforced;

(4) The composition of the arbitral authority or the arbitral procedure was not in accordance with the law where the arbitration took place; or

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[23] Pursuant to rule 4 (k) of the Federal Rules of Civil Procedure, personal jurisdiction can generally be established over the defendant at the district court in the state where the defendant is subject to the jurisdiction of the state court of general jurisdiction.

(5) The award has not yet become binding on the parties, has been set aside, or suspended by a competent authority of the country in which that award was made.

### 3. Refusal to Recognize and Enforce a Foreign Arbitration Award

The United States court in which arbitration is sought may also refuse to recognize and enforce the foreign arbitration award if:

(1) The subject matter of the dispute is not capable of settlement by arbitration under the law of the United States; or

(2) The recognition or enforcement of the award would be contrary to the public policy of the United States.

Antitrust claims are examples of disputes which may not be capable of settlement by arbitration in the United States. Under United States law, antitrust matters are entrusted to the exclusive competence of the judiciary.[24] However, the courts have determined that the defense that the subject matter is not capable of settlement under the laws of the United States is more narrowly applied to enforcement of international arbitration awards as compared to domestic arbitration awards.[25]

For example, in *Scherk*, the court decided whether an arbitration provision was enforceable relative to an international claim involving securities issues. The court had previously decided in a domestic case that securities issues are normally not capable of settlement by arbitration.[26] In deciding that securities issues did not preclude an international claim, the court reasoned that international agreements involve considerations and policies significantly different than domestic agreements. In an international case, considerable uncertainty exists concerning the law applicable to disputes arising out of the contract.

> Such uncertainty will almost inevitably exist with respect to any contract touching two or more countries, each with its own substantive laws and conflict of law rules. A contractual provision specifying in advance the forum in which disputes will be litigated and the law to be applied is, therefore, an almost indispensable precondition to achievement of the orderliness and predictability essential to any international business transaction. Furthermore, such a provision obviates the danger that a dispute under the agreement might be submitted to a forum hostile to the interests of one of the parties or unfamiliar with the problem area involved.

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[24] Parsons & Whittemoore Overseas Co., Inc. v. Societe Generale De L'Industrie Du Papier (RAKTA), 508 F.2d 969, 975 (2nd Cir. 1974).

[25] Parsons & Whittemoore Overseas Co., Inc. v. Societe Generale De L'Industrie Du Papier (RAKTA), 508 F.2d 969, 975 (2nd Cir. 1974), at p. 975.

[26] Wilco v. Swan, 346 U.S. 427 (1953).

> A parochial refusal by the courts of one country to enforce an international arbitration agreement would not only frustrate these purposes, but would invite unseemly and mutually destructive jockeying by the parties to secure tactical litigation advantages.[27]

#### 4. Public Policy Defense

The public policy defense is construed narrowly by United States courts. Enforcement of an arbitration award will only be denied based on public policy when enforcement of the award would violate the forum state's most basic notions of morality and justice.[28]

#### 5. Arbitration Agreements

Under the Convention, the United States recognizes agreements in writing under which the parties undertake to submit to arbitration all or any differences which have arisen or which may arise between them in respect to a defined legal relationship, whether contractual or not, concerning a subject matter capable of settlement by arbitration.

Standardized arbitration provisions are found in widely acceptable construction agreements and are published by various arbitration associations. The arbitration agreement can include a provision within the original contract for construction, or could be entered into after a dispute has arisen. In the event that one of the contracting parties is a sovereign, the agreement should include a waiver of any statutory limitation of arbitration proceedings. The arbitration agreement can determine the forum, choice of law, and the rules to be applied to the arbitration proceeding. The agreement should specify the events that will trigger a party's rights to arbitration. Once a party's right has been triggered, the provision can provide notice requirements to the other party allowing a period to attempt resolution prior to the application for arbitration.

The agreement can determine whether the arbitration is binding or whether either party can reject the finding of the arbitrator and seek judicial review. In the event that the parties decide against a binding arbitration decision, a provision which would charge costs and attorney's fees to the party seeking judicial review if the arbitration award was challenged would inevitably discourage parties from challenging the award.

While the arbitration fees are generally split between the parties, the parties can agree to allocate the arbitration fees to the losing party or to the party that applies for arbitration. The arbitration agreement can also set the limits for the award of any

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27 Scherk v. Alberto-Culver Co., 417 U.S., at pp. 516 and 517.

28 Whittemoore Overseas Co., Inc. v. Societe Generale De L'Industrie Du Papier (RAKTA), 508 F.2d., at p. 974.

dispute submitted to arbitration. The arbitration can set the maximum limit for any award as well as the minimum limit for any dispute that is submitted to arbitration.

### 6. Arbitration Proceedings between Related Contracts

The contracting parties should also consider the coordination of arbitration proceedings between related contracts. A construction project can include numerous contracts, including design and engineering contracts, construction contracts, a number of subcontracts, and supply contracts. A single dispute can impact not only on the general contractor, but also on a number of subcontractors and suppliers. In judicial proceedings, all disputes arising out of common facts and circumstances would be brought in the same proceeding. Joining all common disputes within a single proceeding would eliminate the danger of inconsistent determinations regarding common operative facts.

For example, in one dispute between the owner and the contractor, it may be determined that certain electrical work directed by the owner was within the scope of the general contract and included within the electrical plans and specifications. In a different dispute between the contractor and the electrical subcontractor, a different arbitration panel finds that the electrical work originally directed by the owner and subsequently directed by the contractor was not within the scope of the electrical plans and specifications. The contractor, having lost the dispute against the owner for an adjustment to contract price in one arbitration proceeding, now must pay the claim from its electrical subcontractor because of inconsistent rulings of two different arbitration panels.

In a judicial proceeding within the United States, theories of *res judicata* and collateral estoppel would minimize the risk of inconsistent judicial proceedings. However, a party that is not given the opportunity to present evidence in one proceeding should not be barred from addressing the same issue in another proceeding. The procedural rules in the United States generally allow all claims relative to the same fact and occurrences in one proceeding.

### 7. Forum and Rules for Arbitration Proceedings

There are several recognized arbitration associations which provide a forum and rules for arbitration proceedings. Certain arbitration associations have specific rules for international arbitration proceedings and have approved arbitrators that are familiar with international arbitration rules. There are also recognized rules for international arbitration including UNICITRAL Arbitration Rules and the Asian/Pacific Center for Resolution of International Business Disputes.

The rules can provide for the selection of an arbitration panel usually consisting of between one and three arbitrators. An arbitration panel of three arbitrators can allow for each party to select a single arbitrator and the two arbitrators can then select a third arbitrator.

Discovery rules can limit discovery to allow for an efficient resolution of small disputes. For large complex matters, the discovery rules can provide mechanisms to resolve discovery disputes and to move the process forward to arbitration. For example, instead of requiring all discovery disputes to be handled by the entire arbitration panel, a single arbitrator could be selected by the parties to act as a discovery master. The rules should also provide expert disclosure requirements.

As the type of matter submitted for resolution becomes more complex, many of the arbitration management concerns are similar to the case management concerns in a judicial proceeding. However, the arbitration process inherently provides greater flexibility than the judicial process for the parties to manage a particular matter. While a judicial proceeding can allow parties to draft a case management order, the case management order is subject to approval by the judge, and limited by the local court rules and the forum's rules of civil procedure. On the other hand, arbitration rules are by nature selected by agreement of the parties to the dispute.

## E. LETTERS OF CREDIT AND SURETY AGREEMENTS

### 1. Letter of Credit Contracts

The letter of credit (LOC) has historically provided a method to insure payment in commercial settings. The LOC generally involves three separate contracts. First, there is a contract between two contracting parties for goods or services. Second, one of the two contracting parties will then enter into an agreement with a bank where the bank agrees to issue a letter of credit insuring payment on behalf of its customer. Third, the bank then issues a letter of credit to the second contracting party which obligates the bank to pay the payee, when the payee presents the bank with a draft and certain predetermined documents.

The International Commerce Commission (ICC) has published rules encompassing the issuance and exchange of documentary credits.[29] The ICC rules specify the obligations and liabilities of the banks[30] and beneficiaries of LOC's. For example, the issuer has the obligation to examine the documents tendered by the beneficiary to determine whether the documents are consistent and comply with the terms of the LOC. Conditions specified in the LOC which do not reference documents are to be discarded by the issuer. The bank must determine, on the basis of the documents alone, whether or not they appear on their face to be in compliance with the terms and conditions of the LOC. If the issuer determines that the documents are not in compliance with the terms of the LOC, the bank may, at its discretion, approach the applicant for a waiver. If the bank refuses to accept the documents tendered by the beneficiary, it must provide notice identifying the discrepancies within

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[29] ICC Uniform Customs and Practice for Documentary Credits (Publication 500).

[30] The term "banks" includes issuing banks, confirming banks, advising banks, and any other nominated bank.

seven days from the date in which the documents were tendered. The issuers of LOC's can incorporate the ICC Rules by reference to the ICC Rules on the face of the LOC.

## 2. Discrepancies within Documents

A number of issues may arise which are not addressed by the international rules. Many such cases are related to the determination of whether certain discrepancies within the documents justify a refusal by the bank. The terms of the LOC's are generally not negotiated like the underlying contracts between the applicants and beneficiaries. The applicant will generally determine the requirements for the LOC which, in many cases, can have unreasonable expiration dates, or terms which may be inconsistent or unreasonable.

Beneficiaries of LOC's have brought complaints to enforce payment within the United States resulting in the development of a body of law which addresses issues beyond whether or not the documents strictly complied with the LOC. In interpreting the requirements of a particular LOC, a number of jurisdictions have decided that the LOC shall be interpreted according to the rules for ordinary contracts. Where there is an ambiguity in the terms of the LOC, the LOC is construed against the issuer. Consistent with the ICC Rules, any conditions within the LOC which require the bank to examine the beneficiary's performance under the underlying contract are disregarded as surplusage.

In several instances, the beneficiary has been unable to obtain payment because the documents were tendered after the expiration date of the LOC. In most instances, the expiration date has been determined to be a binding and important term of the LOC. However, in some cases, the court has determined that the expiration date was inconsistent with other terms of the LOC and has extended the date to allow the beneficiary to enforce payment.[31]

In *Exxon*, a standby LOC was issued to guarantee performance between September and December of 1981, and the letter allowed the beneficiary to draw on the LOC on presentation of a document certifying that the applicant had defaulted and failed to perform. Another provision within the LOC required the beneficiary to present the document no later than October 31, 1981. The certification was tendered after October 31, 1981, and the bank refused to make payment on the LOC. The beneficiary brought an action to enforce the LOC, and the court determined that the provision requiring payment by October 31, 1981 was in irreconcilable conflict

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[31] Exxon Company, U.S.A. v. Banque De Paris Et Des Paysbas, 889 F.2d 674 (5th Cir. 1989), which interpreted Texas law.

with the provision allowing for payment if the applicant defaulted between September and December of 1981. The court construed the LOC against the issuer and directed payment to the beneficiary.[32]

The commercial letter of credit would historically be arranged to provide payment for transactions between two merchants. A merchant shipping goods in one country would require a purchaser to provide a letter of credit issued from a designated bank which would obligate the bank to make payment on drafts presented by the seller when accompanied by a bill of lading. The LOC was an important instrument in that it guaranteed payment to the seller on delivery of the goods for shipment, rather than requiring the seller to risk the possibility of non-payment by a party in another country.

### 3. Construction Projects

The standby letter of credit is more prevalent in construction projects. A contractor will issue a standby letter of credit to guarantee payment in the event of default by the contractor. For example, in one case, a standby letter of credit was issued to satisfy any penalties awarded by a tribunal for a breach of contract by a contractor in the construction of a paper mill.[33]

Standby letters of credit have been compared to performance bonds which are generally issued by surety companies. However, standby letters of credit are significantly different from performance bonds. The doctrine of independence can require the bank to pay the owner on presentment of pre-designated documents regardless of underlying contractual defenses.

On the other hand, a performance bond incorporates the construction contract creating the necessity for the resolution of underlying contractual issues prior to the release of payment. As a surety bond provides a mechanism for the contractor to adjudicate all contractual defenses prior to payment, the contractor may prefer to provide a surety bond rather than a standby letter of credit.

### 4. Performance Bonds

Performance bonds are generally issued by a surety of the general contractor to assure that the work will be completed and that all obligations are fulfilled in the event that, the general contractor defaults in its performance of its construction agreement. The determination of the owner's right to bring an action against a surety revolves around whether the owner is a direct beneficiary pursuant to the

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[32] Exxon Company, U.S.A. v. Banque De Paris Et Des Paysbas, 889 F.2d 674 (5th Cir. 1989), at p. 678.

[33] See Parsons & Whitmoore Overseas Co. Inc. v. Society Generale De L'industrie Du Papier (RAKTA) et al., 508 F.2d 969, 972 (2nd Cir. 1974), where the court did not address the declaratory judgment appeal to prevent the draw on the letter of credit.

terms of the bond. As the performance bond requires the surety to undertake and complete all obligations placed on the contractor by the terms of its contract, it has been determined that the owner is a direct and not an incidental beneficiary of the performance bond.[34]

Pursuant to the terms of the performance bond, the contractor and the surety generally and severally bind themselves to the owner for the performance of the construction contract. The contract is usually incorporated within the bond by reference.

Furthermore, the surety will generally obligate itself to the owner with respect to various other obligations of the contractor, including:

(1) The responsibilities of the contractor for the correction of defective work and completion of the construction contract;

(2) Additional legal design and delay costs resulting from the contractor's default; and

(3) Liquidated damages or, if no liquidated damages are specified in the construction contract, actual damages caused by delayed performance or nonperformance of the contractor.

The wording of the provisions within the performance bond generally bind the surety to the owner to the same extent that the contractor would be bound to the owner for any damages resulting in a default by the contractor under the construction contract. In contrast to the LOC, which is independent of the construction contract and requires payment on submission of the required documents, the surety agreement incorporates all of the defenses that the contractor would have in the event of a dispute, necessitating resolution of various defenses and claims prior to payment.

To trigger the obligations of the surety, the owner generally must notify the contractor that it has defaulted under the contract and that it has a specified amount of time to cure the default. If the contractor fails to cure the default within the specified amount of time, the owner can than provide the contractor with a notice of termination. Once the contractor has been terminated, the surety generally has three options:

(1) It can accept the balance of the contract amount and finish the contract work;

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[34] The Village of Fox Lake v. Aetna Casualty and Surety, 178 Ill. App. 3d 887, 534 N.E.2d 133, 147–148 (2d. Dist. 1989).

(2) It can agree to allow the owner to complete the contract work and pay the owner the difference between the remaining contract amount and the cost to complete the work; and

(3) It can pay out the amount of the bond and discharge its surety obligation.

## F. INSURANCE

The contractor will usually have a commercial general liability policy (CGL policy) which is generally a third-party liability policy. The third party liability policy is a general contractors policy and usually insures against lawsuits by other parties for property damage and personal injury. Examples of claims that may be covered by the CGL policy include nuisance claims by neighbors to the construction site and claims by persons who are not employees of the contractor that are injured on the site. The CGL policy generally does not cover contractual risk, such as defective work by the contractor or the contractor's failure to perform under its contract. However, to the extent that the contractor damages property, other than that encompassed by its own work, coverage may be available. In many cases, the owner will request to be named as an additional insured by endorsement, to provide protection in addition to the indemnification agreement provided by the contractor.

The additional insured endorsement can provide protection to the owner for personal injury claims by employees of the contractor or its subcontractors. In the event that the contractor and insurer are from the United States, the international owner will want to determine that the policy's coverage goes beyond the limits of the United States and that the insurance carrier is admitted and can provide a defense in the areas where a claim will most likely be brought.[35]

The contractor or owner may also purchase a builders risk policy to insure against perils which can damage the project during construction. The owner should be named as a beneficiary to the policy which, unlike the CGL policy, is a first-party property policy in that it pays for property damage suffered by the insured. The owner should require sufficient limits within the policy to cover the cost of the completed project. The policy period should allow completion of the project so that the risk could then be transferred to a property policy.

The builders risk policy will usually cover the structure, although inevitably there will be equipment and material stored at the project site not yet incorporated into the project. The coverage should be broad enough to cover all property which is at the insured's risk whether in transit, stored at the site, or incorporated into the structure. The policy generally excludes defective work and materials, and

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[35] While a claim will usually be brought at the location of the injury, there is also the possibility that the claim can be brought in the jurisdiction in which the claimant was originally employed, particularly if the parties are subject to jurisdiction at that location.

defective design. It will also exclude such perils as war, arson, sabotage, and theft. In addition to replacement costs, some builders risk policies may cover costs resulting from the delayed opening of the project.

The engineer and architect should provide professional malpractice policies to cover the risk of loss due to defective design. Professional malpractice policies cover claims alleging negligent acts, errors, or omissions. The coverage can include personal injury, property damage, and economic damages, such as construction costs resulting from the error or omission.

## G. CONCLUSION

Given the number of United States corporations involved in the construction of projects around the world, there is a strong likelihood that disputes involving corporations from the United States will occur. Because of the number of United States participants involved in multinational projects, it is likely that disputes concerning a construction project anywhere in the world will eventually enter the United States judicial system. The resolution of claims within the United States requires knowledge of United States procedural law and the methods to enforce foreign judgments and foreign arbitration awards. Letters of credit, surety bonds, and insurance can provide invaluable assistance in the risk management of a large multinational project.

CHAPTER 14

# PUBLIC PROCUREMENT IN GERMANY

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## A. INTRODUCTION

### 1. Term

The term "Law of Public Procurement" includes all provisions and regulations that assert how the state, administrative bodies, and institutions must proceed when purchasing goods and services. In this context "purchase" is every requisitioning of goods and services transaction for reward.

Thus, "Law of Public Procurement" covers, e.g., regulations stating how a local authority (municipality) must proceed when looking for an architect to build a new waste incinerator. Aside from these regulations, public utilities, such as telecommunication enterprises or public transport companies, must apply the "Law of Public Procurement".

### 2. Importance of Public Procurement

According to recent estimates, the entire volume of all public orders (procurements) in Germany amounts to approximately € 200 billion per year. Public Procurement therefore makes up around 10–15 per cent of the German gross domestic product. Within the European Union, the volume of public procurements reaches an amount of approximately € 700 billion (approximately 11 per cent of the European Union (EU) gross domestic product.

Public procurements are made especially in the area of construction works. Public orders and their allocation play an important role. Thus, participation in public procurements, especially in those areas concerning construction, is an interesting and important field for private companies, either national or international. In Germany, approximately 60 per cent of all public orders come from local authorities (municipalities), thus being the most important customers.

Most of these public orders are within the scope of the German Statute of Public Procurement (*Vergaberechtsänderungsgesetz*), which entered into force on 1 January, 1999. The enactment of these new legal provisions, which have been integrated

into the German Antitrust Statute (*Gesetz gegen Wettbewerbsbeschränkungen*), was necessary to adapt the (traditional) national German law to numerous EU Procurement Directives.

Nonetheless, since the new regulations only apply to procurements exceeding certain threshold values while, to those below, these values the old legal rules are still applicable, it is necessary to also consider the legal situation in Germany before 1999.

### 3. Legal Situation before 1999

Until January 1999, the national German procurement regulations only served to protect public budgets, i.e., to ensure economic use of public funds. Thus, in case of illegal procurement practices, the individual bidder had very little legal protection.

#### a. *Until 1993*

Until January 1993, most regulations concerning public procurement were contained in Budget Acts, e.g., section 7 of 55 Federal Budget Act (*Bundeshaushaltsordnung*). According to them, public invitations to tender were only necessary to assure that the most economic and best quality bid was awarded the contract.

The procurement procedure itself was, and still is, regulated by Standard Official Contracting Terms. In case of public procurements concerning construction the Standard Building Contract Terms (VOB) or, in case of other procurements Standard Service Contract Terms (VOL), apply. These terms, that were generally not *per se* legally binding, contain provisions as to public invitation of tenders, deadlines for the bidders, investigation and evaluation of the different bids, awarding of contract, and notification of the award.

The bidder himself was not granted any individual rights. Therefore, he could not sue the public customer or his competitors for breach of procurement rules and was unable to prevent or delay awarding of the contract to any of his competitors. In case of breach, all he could get was a refund of costs incurred during the preparation of his bid.

#### b. *Since 1993*

In 1993, Germany transferred different EC Directives on public procurement into national law. These Directives concerning construction, services, and delivery (*Lieferkoordinierungsrichtlinie, Baukoordinierungsrichtlinie, Dienstleistungsrichtlinie, Sektorenrichtlinie, Rechtsmittelrichtlinie and Sektoren-Rechtsmittelrichtlinie*) had been designed by the EU Commission to coordinate the differing national procurement regulations, assure freedom of services, and grant transparency and effective legal protection in case of breach of procurement rules.

When transferring the Directives, Germany generally stuck to its traditional budget law system and again implemented the new provisions into Budget Acts, especially into the "Statute of Basic Budgetary Rules" (*HaushaltsgrundsätzeG*).

Under European law, the Directives were only applicable above certain threshold values that were fixed as follows:

(1) Threshold values for delivery and services = ECU 200,000 (approximately DM 384,000); and

(2) Threshold values for construction = ECU 5 million (approximately DM 9.6 million).

Thus, the German law of public procurement became divided into those procurements below the threshold values and those over it.

**I. Below the Threshold Values.** To those procurements which were under the threshold values as fixed in the EC Directives, the old German legal provisions were applicable.

Thus, a bidder had (and still has) no individual rights. The legal provisions only applied to the traditional public customer, i.e., the Federation, *Länder*, and municipalities, so that "modern forms" of public companies were not bound. As in the past, the standard official contracting terms were not *per se* legally binding, but needed to be agreed between the respective parties to the contract.

**II. Over the Threshold Values.** In contrast, where a procurement was over the threshold values, the new legal provisions as laid down in the Statute of Basic Budgetary Rules (*Haushaltsgrundsätzegesetz*), sections 57a–c and in additional regulations (*Vergabeverordnung, Nachprüfungsverordnung*), became applicable. They apply to both "traditional" and "modern" public customers (like companies in private legal form, whose majority shareholder is a public body). In addition to the Statute of Basic Budgetary Rules, the standard official contracting terms were declared as being legally binding.

Finally, special examination bodies, e.g., the Procurement Examining Agency (*Vergabeprüfstelle*) and the Procurement Supervision Committee (*Vergabeüberwachungsausschuß*), were installed that had to control compliance with procurement rules on appeal of a bidder. Nevertheless, there was, again, no legal possibility for a bidder to go to court and sue for non-compliance with procurement rules. In case of non-compliance with procurement rules, the bidder to whom the contract had not been awarded could only sue for damages (which he had to prove), but had no legal right to sue for awarding of the contract to himself.

Because of this, the EU Commission soon started a procedure for breach of EU contract against Germany before the European Court. In 1995, the European Court finally decided against Germany. As to the Court, the Directives aim to grant

individual rights to bidders and to protect them from infringement of procurement rules. Thus, national law adapting these Directives must assure that every bidder is having the possibility to go to court and sue for infringement of procurement rules.

In 1996, the United States requested Germany to install provisions, against which every bidder could generally go to a national court and appeal against infringement of procurement rules. From the United States view, United States bidders had been discriminated in some public procurements (e.g., GE/VEAG or Westinghouse/City of Cottbus). Thus, the United States government threatened Germany with trading sanctions. As a result of the decision taken by the European Court in 1995 and the United States threats, the German government started to reform the national law of public procurement. This reform finally resulted in the German Statute of Public Procurement (*Vergaberechtsänderungsgesetz*) of September 2, 1998, that entered into force on January 1, 1999.

## B. LEGAL SITUATION SINCE JANUARY 1999

### 1. General

The new legal provisions laid down in the German Public Procurement Act (*Vergaberechtsänderungsgesetz*) have been integrated into the German Antitrust Act (*Gesetz gegen Wettbewerbsbeschränkungen*, GWB). Section 4 of the Antitrust Act (sections 97–129) is thus now forming the new legal basis of public procurement in Germany.

Besides general principles (like prohibition of discrimination of bidders, prohibition of consideration of irrelevant aspects, and priority of the most economic bid) the new regulations also contain a wider definition of those customers falling within the scope of the law, detailed regulations concerning examination bodies (including court), and regulations concerning damages. Besides, for the first time in German history, the new regulations are expressly granting the bidders an individual right to sue for compliance with procurement rules.

### 2. Application of the New Legal Provisions

The new provisions are generally only applicable to public procurements that exceed the threshold values as laid down in the different EU Directives.

Since the European Union has meanwhile signed the "General Procurement Agreement" (GPA), to which the United States also is party, the ECU as a unit of measurement for the threshold value has been replaced by special drawing rights (SDR), since October 1998.

Thus, the current threshold values for construction is SDR 5 million (approximately ECU 5.15 million) and SDR 200,000 (approximately ECU 206,000) for delivery and services.

The threshold value is calculated on the basis of estimated total value of the order, excluding value added tax. It is prohibited to divide an order into different ones only to avoid application of procurement rules. Division is only allowed for objective reasons, e.g., in case of construction of a larger building, division between different, non-relating units is permitted. In case (public) building orders are awarded in different lots, the new procurement regulations are applicable if each individual lot has an estimated value of at least SDR 1 million.

Thus, the division of German law of public procurement which existed in the past is still continuing. While the new rules only apply to orders or businesses exceeding the EU threshold values, to those being below these limits, the old budgetary provisions are still applicable.

### 3. Public Customers

Public procurement only applies to public customers. The general division (below and above the EU threshold values) of public procurement creates various definitions of "public customer".

#### *a. Public Customer in Traditional German Law*

Procurements below the EU threshold values, are governed by traditional German law of public procurement, based on Budget Acts. According to these provisions, all public institutions which are bound by public budget law, must apply procurement rules. These prepositions are mainly fulfilled by the "traditional " public bodies, i.e., the Federal State, *Länder*, the municipalities, and their respective bodies governed by public law.

Public institutions to which the Budget Acts have not expressly been declared applicable are not bound by national procurement rules and are thus not obliged to apply procurement law to orders below the EU threshold value. Public procurement rules did not therefore apply to the former Federal Privatization Agency (Trusteeship Administration).

Natural persons or juristic persons governed by private law generally do not need to apply public procurement rules, unless expressly — by special act of state — ordered to do so.

#### *b. Public Customer in New German Law of Public Procurement*

Procurements over the EU threshold value are governed by the new Public Procurement Act, which incorporates EU law. Those transactions in this context are to be regarded as "public customers" if listed in section 98 of the GWB. While under traditional German law "public customers" are defined on an institutional basis, the new legal provisions, following the Directives, are using a functional definition.

Thus, under the new procurement rules, not only the traditional public bodies, i.e., Federal State, *Länder*, municipalities, and their respective bodies governed by public law but also all juristic persons governed by public or private law that have been incorporated to fulfill non-commercial tasks being of public interest and that are mainly financed or controlled by local authorities are to be regarded as "public customers".

A juristic person is controlled by local authorities in case the latter are holding more than 50 per cent of its shares. Besides, control is also given, in case the juristic person is mainly financed on a private basis, but its management is mainly (more than 50 per cent) determined by local authorities.

Thus, for example, most of the public utilities (*Stadtwerke*) being organized as juristic persons governed by private law (especially as a limited company) are to be regarded as a "public customer" and are therefore obliged to comply with procurement rules when awarding contracts the estimated value of which is exceeding the respective EU threshold value.

To be regarded as "public customer", the respective juristic person, besides mainly being financed or controlled by local authorities, also needs to fulfill tasks of public interest. In case of juristic persons governed by public law, it is generally assumed that they have mainly been installed to fulfill such public tasks. In case of juristic persons governed by private law, it is also necessary to assure that their purpose is non-commercial.

A commercial purpose is given if the juristic person in question is mainly acting to gain profit. In case it is mainly acting to fulfill tasks being of public interest, independent of whether it is thereby gaining profit or not, it is to be regarded as "public person" and thus "public customer", even if the fulfillment of the task being of public interest is profitable.

Thus, in case of juristic persons governed by private law, it may from time to time be pretty difficult to decide whether they are regarded as "public customers". Such decision needs to be taken individually.

Although this uncertainty, especially with regard to juristic persons governed by private law, is one of the main weak points of the new regulations, such uncertainties cannot be completely avoided unless they are replaced by a clear but inflexible definition.

Companies acting on special sectors are "public customers" and thus bound by procurement rules, if they are under state control or, as private companies, acting on the basis of exclusive rights. In this context, it does not matter whether the sector company is fulfilling tasks of public interest or mainly gaining profit. The sectors covered by the new legal provisions are the supply of drinking water and energy, passenger transportation, and telecommunication.

## 4. Types of Procurement Procedure

The division of German law of public procurement also is reflected in the different procurement procedures generally being available.

### a. *Traditional German Law*

In traditional German law, which is still applicable in case of procurements below the EU threshold values, there are three different kinds of procurement procedures:

(1) Public invitation to tender;

(2) Limited invitation to tender; and

(3) Open invitation to tender.

While public invitations to tender are generally addressed to an unlimited number of bidders, limited and open invitations to tender are addressed to a limited, pre-selected number of bidders.

In case of public and limited invitations to tender, both form and procedure are regulated in detail in the Standard Official Contracting Terms. In contrast, there are hardly any regulations concerning open invitations to tender.

### b. *Modern German Law*

Above the EU threshold values and, thus, as to the new regulations contained in the Antitrust Act (GWB), the different kinds of procurement procedure are, in comparison to the traditional rules, named differently, although the underlying rules of procedure are comparable.

Instead of "public invitation" the new regulations (section 101 of the GWB) are talking about "open invitation"; the "limited invitation" is now called "non-public invitation", and the "open invitation" is now defined as "negotiating invitation".

Under both legal rules, i.e., the traditional and the modern ones, public customers are generally not free to choose between the different kinds of invitations to tender. They are bound to the hierarchy of the different kinds of invitation.

According to this hierarchy, the public/open invitation is prior to the limited/non-public and the open/negotiating ones. This hierarchy shall ensure transparency of public procurement as well as more extensive competition between the bidders.

In deviation from these general rules, in case of allocation of freelanced services exceeding the threshold value, also public customers must apply the regulations concerning negotiating invitations to tender. Thus, in this case, there will always be a prior competition of participation that needs to be announced in the *Official Journal*

of the EU. Those who want to participate are asked to announce their interest. On the basis of this announcement, the customer will then decide, whom he will ask to present an official offer.

While, as pointed out, public customers are generally bound to the hierarchy of the different kinds of invitation, the private sector companies are free to choose between them.

## 5. Procurement Procedure

### a. *General Principles (section 97 of the GWB)*

The following general principles apply to all procedures, either public/open, limited/non-public, or open/negotiating:

**I. Principle of Competition.** The principle of competition means that as many bidders as possible shall be given the opportunity to offer their services. Therefore, a public/open invitation to tender has priority.

**II. Prohibition of Discrimination/Principle of Equal Treatment.** Under this principle, all bidders must be treated equally in all stages of procedure. Thus, it is prohibited (although often wanted by local politicians) to give preference to resident companies. It is not even allowed to provide them with better information about the procedure or the services asked for than other, non-resident bidders.

The authority is not allowed to publish the invitation to tender in Germany before publication has been sent to the EU *Official Journal*. Both the national publication and the one in the EU *Official Journal* need to contain the same information, to avoid that foreign bidders are discriminated against.

Finally, this principle prohibits a bidder to correct his offer after expiration of the invitation deadline.

**III. Prohibition of Irrelevant Factors.** This principle is parallel to the prohibition of discrimination. The one the contract is awarded to is to be selected because of his efficiency, know-how, and reliability. Due to the underlying Directives other demands, such as payment of standard wages or support of female employees, are not to be considered.

Nonetheless, the Statute of Public Procurement allows to consider such additional demands, in case they are contained in state law and — for an interim period until June 30, 2000 — in existing subordinate legislation.

**IV. Prohibition of Negotiation.** Prohibition of negotiation does not apply in case of open/negotiating invitation to tender, the customer is bound to his invitation to tender and the information contained therein. Thus, he is generally not allowed to change the prepositions of his invitation to tender in the course of the procurement procedure.

**V. Principle of Awarding by Lots.** As to this principle, extensive performances, especially in construction and delivery, shall be divided into smaller lots, to ensure that also smaller companies are having a chance to participate in the procedure.

**VI. Principle of Commercial Efficiency/Profitability.** The contract must be awarded to the bidder who has made the most efficient offer. In this context, not only the price itself, but also aspects like quality or consequential charges shall be taken into account.

*b. Course of Procedure*

**I. Publication.** Generally, every procurement procedure starts by publication of the invitation to tender. In case of procurements exceeding the threshold values, the invitation to tender needs to be published in the *EU Official Journal*.

The content of these publications is strictly regulated in specimen forms. These forms, that are based on the Directives, are applicable throughout the EU. In Germany, they are annexed to the Standard Official Contracting Terms. The provisions concerning publication are binding. Thus, in case of breach, the procurement procedure as a whole can be illegal.

**II. Dispatch of Official Tender Documents.** The deadlines for dispatch of the official tender documents are laid down in the respective standard official contracting terms; they are generally binding. In these documents, a bid acceptance period is notified.

**III. Receipt of Tenders.** Within the bid acceptance period, the customer will receive the tenders. Often the incoming tenders, both from smaller and big companies, do not fulfill the formal prerequisites laid down in the Standard Official Contracting Terms and the tender documents, e.g., the proxy of the person who signed the tender is missing or not all members of a bidding syndicate have signed the documents.

**IV. Valuation of Tenders.** When proving the tenders, the customer is allowed some flexibility for evaluation. He is not obliged to award the contract to the tender with the lowest price, but is also allowed to take other aspects, covered by the general principles, into account.

The contract must be awarded to the most efficient tender; here, besides the price itself, also additional aspects like quality or consequential charges should be

taken into account. The customer is obliged to publish his criteria of evaluation either in the publication of the invitation to tender or in the tender documents.

**V. Acceptance of Tender.** Generally, every invitation to tender and, thus, every procurement procedure is terminated by acceptance of a tender, i.e., the entering into a contractual relationship between the customer and the bidder, whose tender is accepted. The invitation to tender can only be cancelled exceptionally for extraordinary reasons.

Due to jurisdiction, the prerequisites that need to be fulfilled are very strict. Thus, e.g., in case no single tender complies with the conditions laid down in the invitation to tender, the customer is not only allowed, but obliged to cancel the whole procedure and start it from the beginning. He is, in this case, not allowed to deviate from his underlying conditions, just to ensure that at least one tender is fulfilling them.

### 6. Legal Protection against Infringement of Procurement Rules

What can a bidder do in case he is of the opinion that the public customer is infringing the rules of public procurement?

#### *a. Below Threshold Values*

According to traditional German budget law that is still applicable to procurements below the threshold values, hardly any subjective right of a bidder to sue for breach of procurement rules exists.

Since the underlying legal provisions mainly serve to protect public budgets, they do not unfold protection in favor of the bidders, applicants, or any other third party.

Thus, primary legal protection, as to which an individual bidder can sue for acceptance of his tender, hardly ever exists. Only in the rare case that, to the individual bidder in question, the contract almost certainly would have been awarded in case of proper application of procurement rules, can the bidder sue for refund of all the losses he suffered because of illegally not having been considered.

In all other cases, the individual bidder can only sue for refund of his costs to participate in the procurement, e.g., costs for his presentation and bid. He is under the obligation to furnish proof of all prepositions, i.e., faulty breach of procurement rules by the customer or suffering of damage.

#### *b. Above Threshold Values*

**I. Basic Budgetary Rules Act.** Under sections 57 b and 57 c of the Basic Budgetary Rules Act, all public procurements are subject to control by Procurement Examining Agencies and Procurement Supervision Committees. In case of infringement

of substantive procurement rules, the Procurement Examining Agencies had to start a procedure on review, either on complaint of a bidder or on general knowledge of the infringement.

If a tender had already been accepted, the Examining Agency was not able to change it. It was restricted to declaration of illegality of the procurement procedure in question. In case a tender had not yet been accepted, the Examining Agency could suspend the procedure and oblige the public customer to reverse illegal decisions already taken and to replace them by legal ones.

Against the decision of a Procurement Examining Agency a bidder could appeal to the Procurement Supervision Committee. Such committees existed both on the federal basis and on the basis of the different *Länder*; thus, each *Land* used to have its Supervision Committee. The Federal Procurement Supervision Committee was installed at the Federal Cartel Office, and its members were independent. In case the Procurement Supervision Committee came to the result that the decision taken by the Procurement Examining Agency was illegal, it ordered the Agency to take a new decision under consideration of the opinion of the Supervision Committee.

This system of legal protection, based on the Statute of Basic Budgetary Rules, was applicable until December 31, 1998.

**II. Public Procurement Act.** Since January 1999, the new Public Procurement Act applies to public procurements above the threshold values and has meanwhile supplemented the older provisions of the Basic Budgetary Rules Act that turned out to be insufficient to protect the bidder against infringement of procurement rules.

The new system of legal protection is contained in sections 102ff of the German Antitrust Act (GWB). As to these provisions, the individual bidder now has a statutory claim that the awarding body must adhere to the procurement rules. This claim may be grounds for an independent, two-stage legal procedure.

### c. *First Stage of the Legal Procedure*

According to section 104 of the Antitrust Act, the Federal Government and the German *Länder* are to establish "Procurement Chambers" (administrative bodies), which are consisting of three members (a chairman and two assessors, one of them being a full-time, the other one a honary member), elected for five years. As a judicial body of first instance, the Chambers are specifically and exclusively entitled to examine the legality of procurements in their respective areas. Again, the Federal Procurement Chamber is installed at the Federal Cartel Office. The procedural regulations concerning Procurement Chambers are contained in sections 107ff of the Antitrust Act.

The Procurement Chambers may only become active on application for judicial review. The application must be made in writing and needs to be justified. Thus, in

contrast to the old regulations contained in the Basic Budgetary Rules Act, the Procurement Chambers will not start to review a procurement procedure *ex officio.*

According to section 107, subsection 2, of the GWB, application for judicial review can be made by every company:

(1) Having an interest in being awarded the contract;

(2) Being of the opinion that its rights have been infringed by illegal application of the procurement rules; and

(3) Being able to prove that it suffers or is about to suffer damages because of this infringement.

In contrast, it is not necessary for the applying company to prove that, in case of proper application of procurement rules, it would have been awarded the contract.

An application for judicial review is inadmissible if the applicant has already been aware of the respective infringement during the procurement procedure and has not immediately criticized it *vis-à-vis* the public customer. In case discernible mistakes are already contained in the publication of the invitation to tender, these mistakes must be criticized until the expiration of the acceptance deadline given in the publication, at the latest. In case of not criticizing in time, application for judicial review will be inadmissible. Besides, an application is also inadmissible after termination of the procurement procedure, i.e., application of tender. In this case, the applicant is restricted to damages.

If an application is not obviously inadmissible or unfounded, the Procurement Chamber serves it to the customer.

After receipt, the customer is no longer entitled to award the contract to anyone until the Procurement Chamber has taken a decision and the deadline to appeal the decision has passed. Thus, admissible appeal for judicial review is generally suspending the respective procurement procedure. However, the Procurement Chamber may, at the request of the customer, allow (as an exemption) the award of a contract if the advantages of a rapid completion of the contract outweigh the disadvantages of delaying the procurement until the end of the examination procedure.

When serving the application to the customer, the Procurement Chamber is asking him to submit the procurement files. After receipt, the Chamber investigates the relevant facts *ex officio.* To be able to do so, the Chamber is, *inter alia*, entitled to fix a (binding) deadline, after expiration of which further arguments of the parties involved can remain unheard.

The Procurement Chamber is entitled to call in companies whose interests can be severely affected by the decision that will be taken. The Procurement Chamber's decisions are based mainly on oral hearings. In the interest of a speedy procedure,

the law designates that the Chamber must take and justify its decision within five weeks of receiving the written application for judicial review. In case of difficult questions that need to be decided, this deadline can be extended by justified decision of the Chamber's chairman.

The Procurement Chamber decides whether or not the applicant's rights are violated. If so, it takes measures to remove the offence and avoid any damage to the affected interests. It is hereby not bound to the content of the respective application, but can influence the procurement procedure independently, as it has the power to investigate the procurement *ultra petita*. The Chamber's decision is enacted as a formal administrative decision, the enforcement of which is subject to the laws of enforcement of administrative judgment.

If the contract has been awarded before examination is applied for, the Chamber cannot annul such contract, even if it was awarded in breach of procurement rules. In this case, the Chamber can only ascertain whether there has been a breach of law. If so, the applicant is entitled to claim compensation from the customer.

### *d. Second Stage*

**I. Court of Complaint.** Against a Procurement Chamber's (negative) decision, an immediate written complaint is admissible. It must be lodged within two weeks after receipt of the Chamber's decision and must be addressed to the respective High Court that is responsible as the Court of Complaint (for second instance, see sections 116ff of the GWB). Thus, as to the actual legal provisions, both judicial and extrajudicial reviews are now granted. To file a complaint representation by lawyers is generally mandatory (exemption: complaint is filed by a juristic person governed by public law).

With a view to the decision taken by the Procurement Chamber, the immediate complaint has a suspensive effect. Thus, even if the Procurement Chamber decided to the advantage of the public customer, he is generally not allowed to award the contract before final decision will have been taken by the Court of Complaint. Only in case of significant reasons does the customer have the possibility to apply for advanced authorization to award the contract before a final decision is taken. This application needs to be justified and in writing.

The Court of Complaint must take its decision within five weeks of receiving the written complaint. There is no legal redress against its decision. In case the Court of Complaint is of the opinion that the complaint is justified, it either replaces the decision taken by the Procurement Chamber or obliges the Chamber to take a new decision on the basis of the legal opinion of the Court.

**II. Costs.** To cover the administrative expenditure, costs (fees and expenses) are charged for examinations made by the Procurement Chambers. The fees range from DM 5,000 to DM 50,000. The defeated party is obliged to pay the costs.

In case of complaint to the respective High Court, costs (for lawyers and the court) are calculated on the basis of the Court Fees Act and the Attorneys' Fee Ordinance. Again, the defeated party is obliged to pay these costs.

**III. Damages.** To ensure that the individual rights now granted to the bidders are not abused, section 125 of the GWB provides that, in case of abuse, damages are payable. As to the legal regulations, abuse is especially given in case suspension of the procurement procedure shall be obtained by the willful and knowing presentation of wrong facts, in case judicial review is only applied for to later withdraw the application in return for remuneration.

In case a company suffered damages because of breach of procurement rules, e.g., costs for presentation and participation in the tender, the public customer is obliged to compensate those losses. An action for damages needs to be filed to the respective civil courts. They are bound to the decisions taken by the Procurement Chamber or, in case of immediate complaint, by the Court of Complaint. Thus, in case they came to the result that certain procurement rules had been infringed, the civil court is bound thereto.

## C. SUMMARY

Although the new procurement rules that have been in force for more than a year, and have been installed to improve the legal situation of those participating in public procurement (especially the bidders), the legal problems are still numerous.

Not only is it necessary for private companies to obtain legal representation when participating in procurements, but also public customers must use lawyers to evaluate the procurement rules prior to any procurement to avoid having their procurements reviewed in the courtroom.

## CHAPTER 15
# PRIVATIZATION IN ROMANIA

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## A. BACKGROUND

### 1. Legal Regulations Relevant to the Privatization Process

Law Number 58/1991, on the privatization of companies, was adopted on August 16, 1991 to transfer the shares and assets of privatized companies into the private sector. Law Number 58/1991 established the State Ownership Fund (SOF) to administer 70 per cent of the aggregate share capital of 6,300 companies about to undergo privatization. Its original objective was to privatize, each year, 10 per cent of the aggregate share capital of the relevant companies so that it could dissolve itself within seven years.

Simultaneously, Law Number 58/1991 created five Private Ownership Funds (POF) to administer the remaining 30 per cent of the aggregate share capital of the 6,300 companies referred to above. In 1996, the POF have been transformed into mutual investment funds.

Although some 804 companies were privatized by the end of September 1994, many of the privatizations were effected through management and employee buy-outs, with few strategic sales and offers to the public being undertaken. In addition, privatization through the transfer of certificates (distributed in accordance with Law Number 58/1991) was limited and the pilot programs were regarded as having been only a minimal success.

As a result of World Bank support, Romania re-embarked on its privatization program in 1996 under the regime introduced by Law Number 55/1995 on the acceleration (stimulation) of the privatization process. In the first stage of this new program, known as the Mass Privatization Program (MPP), all Romanian citizens over the age of 18 received new privatization coupons with a face value of ROL 975,000 (1994 value) which would be issued in respect of the companies or the POF of their choice. The state, represented by the SOF, retained either 51 per cent or 40 per cent of the share capital of the companies in the privatization portfolio, offering the remaining share capital to the MPP. Although it was not that successful at the outset, the MPP was declared a success with a 95 per cent subscription rate by the spring of 1996.

During 1997, the regulations setting up the legal privatization framework were again amended, and it required Government Emergency Ordinances to unblock and stimulate the privatization process.

The Government Emergency Ordinance[1] on the privatization of the commercial companies (privatization ordinance) has established a comprehensive and flexible regulatory framework of the privatization process and has been subsequently approved by Law Number 44/1998. The regulatory framework has been completed by methodological norms of the privatization adopted by Government Decision Number 55/1998.

Government Emergency Ordinance Number 30/1997 on the reorganization of the *regies autonomes*, as approved and amended by Law Number 207/1997, regulated the procedure for reorganization of the *regies autonomes* into joint-stock companies in view of their privatization. According to this Ordinance, the joint-stock companies resulting from the reorganization of the *regies autonomes* engaged in activities deemed to be of national public interest were called national companies and were subject to privatization.

The Privatization Ordinance is supplemented in relation to bank privatization by specific legislation of bank privatization (Law 83/1997 and Emergency Government Ordinance Number 51/1998 on certain measures for the state-owned banks' privatization).

## 2. Institutions Responsible for the Privatization Process

### a. *National Privatization Agency (NPA)*

The NPA was established by Law Number 15/1990, with a view to organizing and coordinating the transfer of shares, as the governmental authority in charge of the coordination, monitoring, and control of the privatization process. The Government Emergency Ordinance[2] dissolved the NPA, its powers being taken over by the Ministry of Privatization (subsequently dissolved).

### b. *State Ownership Fund*

The SOF was established by Law Number 58/1991 and has the following objectives:

(1) Decrease the participation of the state in the share capital of the companies, until their complete privatization;

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[1] Government Emergency Ordinance Number 88/1997.

[2] Government Emergency Ordinance Number 88/1997.

(2) Define criteria of minimal performance to assess the companies, as well as the policy for use of the dividends;

(3) Restructure and rehabilitate the companies and, as the case may be, to liquidate the non-profitable ones;

(4) Fulfill, together with the five POF's, the powers which are granted to the general meeting of shareholders; and

(5) Ensure the management of the state shares which are subject to its administration.

The SOF was initially established as a public institution having legal personality, with a financial and business nature. A Government Emergency Ordinance[3] qualified it as an institution of public interest organized as a closed and atypical investment fund subordinated to the Ministry of Privatization.

Currently, the SOF has become, under Law Number 99/1999 on certain measures regarding the acceleration of the economical reform, a "public institution having legal personality, subordinated to the Government, acting for the reduction of the State's involvement in the economy and the local authorities by selling of their shares". The completion of its activity is foreseen for the end of 2000 when the privatization process should be finalized.

*c. Private Ownership Funds*

The five POF were established by Law Number 58/1991. Unlike the NPA and the SOF, the funds were organized in 1996 as private financial companies.

The aggregate of 30 per cent of the shares owned by the state has been equally divided among the five funds (POF Number 1-Banat-Crisana; POF Number 2-Moldova; POF Number 3-Transilvania; POF Number 4-Muntenia; and POF Number 5-Oltenia). Each POF was granted six per cent of the aggregate share capital of the state-owned companies to undergo privatization.

### 3. Other Relevant Institutions

*a. The Restructuring Agency*

This governmental institution took over several duties, which were, until its establishment, in charge of the SOF. It was set up pursuant to Government Decision Number 780/1993, and its key activities included:

(1) Co-ordination of state-owned companies;

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[3] Government Emergency Ordinance Number 88/1997.

(2) Issuance of restructuring programs;

(3) Obtaining permits and approvals for the relevant restructuring programs; and

(4) Issuance of reports on the way the restructuring process shall develop to be submitted to the government.

This institution was dissolved by a Government Emergency Ordinance,[4] and the Ministry of Privatization took over its responsibilities.

*b. The Ministry of Privatization*

The Ministry of Privatization was set up under Government Decision Number 51/1998 as the institution "in charge with drafting the privatization strategy, privatization laws and regulations as well as the coordination and control activity of the whole privatization process".

The Ministry of Privatization has been dissolved by Emergency Government Ordinance Number 56/1998 on certain measures for the restructuring of the government, its powers being taken over by the Romanian Development Agency.

*c. Romanian Development Agency (RDA)*

The Romanian Development Agency (RDA) was established by the Government Decision Number 182/1991, as a department directly subordinated to the government. The purpose set out by this regulation is the achievement of economic reform and development by inducing and using the capital resources. A Government Emergency Ordinance[5] transformed the RDA into the Department for the Foreign Investments Promotion and transferred it to the Ministry of Privatization which took over the rights and obligations of the RDA.

The RDA has been re-established as an institution (not a governmental department) by Government Emergency Ordinance Number 56/1998, and its duties are set out in Government Decision Number 977/1998 and Law Number 99/1999.

## B. THE CURRENT STAGE OF PRIVATIZATION IN ROMANIA

### 1. General

The privatization process of state-owned companies in Romania has recently undergone certain improvements, namely, the use of competitive and clear privatization methods to ensure the accelerated transfer of state-owned property into

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[4] Government Emergency Ordinance Number 88/1997.

[5] Government Emergency Ordinance Number 88/1997.

private ownership and effective privatization of major companies, including those created by the reorganization of the former *regies autonomes*.

Currently, the key goals of the privatization process refer to:

(1) Speeding up the share sale process through increasing the competition between potential buyers;

(2) Splitting major companies and privatizing the resulting small and medium-sized companies;

(3) Stimulating post-privatization investments by the new owners; and

(4) Separating profitable from non-profitable activities in view of further corporate restructuring.

In order to achieve these goals, the Romanian government decided to offer for sale the shares owned by the state in all companies to be privatized, including those resulting from the reorganization of the former *regies autonomes* of national and local interest.

The current legal framework for privatization in Romania is set out by a Government Emergency Ordinance,[6] as approved by Law Number 44/1998 and amended by Law Number 99/1999.

### 2. Government Emergency Ordinance[7] on the Privatization of Commercial Companies

The Government Emergency Ordinance[8] on the Privatization of Commercial Companies (Privatization Ordinance), was approved by Law Number 44/1998 and further amended and completed by Law Number 99/1999, which dealt with certain measures for the acceleration of the economic reform.

The Privatization Ordinance came into force on December 29, 1997, replacing the existing laws on privatization (Law Number 58/1991, Law Number 77/1994, and Law Number 55/1995) and therefore established a new privatization framework. Subsequently, Law Number 99/1999 came into force on June 27, 1999 and substantially amended and completed the Privatization Ordinance.

The Privatization Ordinance sets out the legal framework for the sale of shares issued by companies that are owned by the state or a local authority, as well as for the sale of assets of the companies in which the state or a local authority is a shareholder.

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[6] Government Emergency Ordinance Number 88/1997.

[7] Government Emergency Ordinance Number 88/1997.

[8] Government Emergency Ordinance Number 88/1997.

It also sets up the sale price based on the relation between demand and supply, providing equal treatment of the buyers, and the possibility of the reevaluation of the companies' debts with a view to making the privatization bid more attractive.

Under the Privatization Ordinance, foreign investors may participate to the same extent as Romanian investors in the privatization of state-owned companies. This principle was reinforced by changes in the law allowing foreign companies to hold property of any nature in Romania (including land) and prohibiting nationalization of privatized companies.

However, the Privatization Ordinance provides that a public Romanian legal entity or a company, in which the Romanian state or an authority of the local public administration holds more than 33 per cent of the shares with voting rights in the General Meeting of Shareholders, cannot act as buyer in the privatization process.

*a. Institutions Responsible for the Privatization Process*

I. **Romanian Government.** The Romanian government implements the privatization policy, coordinates and controls the activity of the ministries and public institutions that are in charge of privatization, takes binding measures for accelerating and completing the privatization process, and is liable for fulfilling such obligations before the Romanian parliament.

To achieve those purposes, the government:

(1) Approves the national privatization strategy;

(2) Approves the essential elements of the mandate contract, including the sale method and the main terms of the contract to be concluded by the public institutions involved with the privatization agents in case of a share sale, or by the companies in case of an asset sale in respect of strategic interest companies;

(3) Grants, as the case may be, exemptions, reductions, deferments, or the rescheduling of the payment of budgetary debts under the proposals submitted by the budgetary creditors or the public institutions involved; and

(4) Takes any other measures as central authority with a view to applying the Privatization Ordinance.

II. **Romania Development Agency.** The RDA performs its activity under Government Decision Number 977 adopted on December 23, 1998, operating as the expert authority of the central public administration, being subordinated to the Government. The RDA is responsible for promoting foreign investments; supervising the performance and completion of the privatization process; coordinating the activities related to the participation of Romania in certain international events; and promoting Romania's image as an investor-friendly environment at international level.

To achieve those purposes, the RDA is authorized to:

(1) Encourage and facilitate foreign investments in the privatization process;

(2) Draft laws and regulations regarding privatization;

(3) Draft reports on the privatization process;

(4) Supervise the privatization operations;

(5) Provide technical assistance to the public institutions involved in respect of privatization; and

(6) Harmonize the restructuring and privatization policies prepared by the ministries that coordinate national companies as well as commercial companies resulting from the reorganization of the former *regies autonomes*.

**III. Public Institutions Involved.** Besides the SOF, which is considered the main institution in charge of privatization, Law Number 99/1999 provides that the relevant ministries or authorities of the local public administration have powers in respect of the privatization of state-owned companies.

These public institutions involved in the privatization process are responsible for the entire privatization process, their main powers being:

(1) The exercise of all shareholder rights of the state or of the local authorities and to mandate their representatives in the General Meeting of Shareholders to vote in support of:

  (a) Efficient management of the state-owned companies that are in their respective portfolios, to increase their attractiveness, including:

   – business, financial, and technological restructuring aimed at improving the company's efficiency and profitability and the reduction of budgetary and other indebtedness;

   – the restructuring of companies by way of a merger, spin-off, asset sale, and debt equity swap, as well as by full or partial voluntary cessation of activity; and

   – the preparation of proposals in respect of budgetary debt relief and restructuring and negotiation of such proposals with the Ministry of Finance and other relevant ministries;

  (b) Liquidation of unprofitable companies; and

(2) To take all necessary steps to carry out the privatization process by:

(a) Selecting the appropriate privatization method;

(b) Publishing the lists of companies to be privatized in the media and on the internet, teletext, and other similar means at local, national, or international level;

(c) Drafting the terms of reference, company outline report, public bid prospectus, or other documents relevant for the privatization process in accordance with the privatization laws and regulations;

(d) Performing the sale at the market price of the shares issued by companies; and

(e) Initiating or, as the case may be, approving under applicable law, the sale at the market price of the assets belonging to companies and *regies autonomes*, except for those subject to the sale procedure according to the Privatization Ordinance.

**IV. State Ownership Fund.** The State Ownership Fund (SOF), which is a public institution subordinated to the government, has an important role acting with a view to decreasing the involvement in the economy of the state and the local authorities by selling the shares owned by the state in commercial companies. The SOF is the main public institution involved.

The SOF carries out its activities in a decentralized manner. For example, companies that are considered small or medium sized (registered share capital lower than ROL 50 billion) may be privatized at the level of the territorial branches of the SOF.

The SOF shall exercise the powers provided by the Privatization Ordinance for the public institution involved in respect of all companies except strategic companies. In respect of the strategic companies, the related ministries shall exercise the above powers. Nevertheless, the government may decide by way of a government decision that the SOF can exercise the powers provided by the Privatization Ordinance also for strategic companies.

In respect of the companies set up under the Law of Local Public Administration Number 69/1991, the powers provided by the Privatization Ordinance for the public institution involved shall be exercised by the local authorities. Such authorities exercise the rights granted to the state as a shareholder and decide on the privatization method in respect of the companies that are in their respective portfolios, resulting from the reorganization of the former *regies autonomes* of local interest (organized by the local authorities).

### 3. Privatization Methods

In accordance with the Privatization Ordinance, privatization shall be performed by:

(1) The sale of shares; or

(2) The sale of assets.

As mentioned above, such shares or assets may be purchased by Romanian or foreign individuals or legal entities, except for the companies in which the Romanian state or an authority of the local public administration holds more than 33 per cent of the voting rights attached to the company shares.

Depending on the national and international economic and political conditions, as well as on the interest shown by the potential buyers or other conditions that might have a negative influence on the results of a certain privatization process, the government may at any time decide to modify a particular privatization strategy, and suspend or interrupt the respective process.

**I. Sale of Shares.** The Privatization Ordinance provides that the sale of shares in a company subject to privatization shall be made either to outsiders (external acquisition) or to insiders — employees and former employees of that company — (internal acquisition).

The shares subject to privatization and managed by the public institutions may be sold by one of the following methods:

(1) An equity capital market transaction, including public offer, and depository receipts issued by investment banks in the international capital market;

(2) Through negotiation;

(3) By an open tender or controlled auction; or

(4) Any combination of the above-mentioned methods.

The sale shall be made at the current market price (without a minimum sale price) and based on an evaluation report.

**II. Sale of Assets.** The Privatization Ordinance provides that the sale of assets of the companies or of the *regies autonomes* in which the state or a public authority holds the majority stake shall be performed by open tender. The assets may be paid by installments to:

(1) Small and medium-sized companies;

(2) Individuals; or

(3) Authorized family associations (a type of association for performing commercial activities).

### a. *State Golden Share*

In case of privatization of companies resulting from the reorganization of the former *regies autonomes* and in case of other strategic companies, the government may decide to keep the golden share. The golden share provides the state with the following rights:

(1) The appointment of 1 or 2 representatives to the Board of Administration of a company; and

(2) The veto power in the General Meeting of Shareholders or the Board of Administration in respect of:

(a) decisions related to the pledge or mortgage of the company assets;

(b) the dissolution and liquidation of the company;

(c) the change of the activity as provided in the company's Statute; and

(d) a merger (by way of absorption), if such decisions adversely affect the consumers and the company's activity by favoring a third party, competition is restricted, or the national interests are adversely affected.

The golden share may be changed any time into an ordinary share by government decision.

### b. *Other Special Provisions*

The amendments to the Privatization Ordinance, introduced by Law Number 99/1999, include a series of mandatory requirements to be satisfied in the privatization process.

**I. Environmental Issues.** The Privatization Ordinance provides that, in the event that a control stake in a state-owned company is to be privatized,[9] such a company shall undertake an environmental audit and draft an environmental report, which shall be submitted for approval to the competent environment authority. The

[9] The term "control" is defined by Government Decision Number 450/1999 and provides that the purchaser has the right to exercise at least one-third of the voting rights in the General Meeting of Shareholders.

approval of such authority must contain the environment-related obligations that must be fulfilled by the company in question.

Based on the approved environment report, the public institutions are obliged to include in the terms of reference or, as the case may be, in the public offer prospectus, the environment-related obligations of the company in question.

The above-mentioned provisions also apply to an asset sale, in case that the company selling the assets carries out an activity qualified by law as having an adverse impact over the environment.

A new provision of Law Number 99/1999 deals with indemnifying purchasers and privatized companies with respect to any environmental obligations arising from the period prior to privatization. This provision sets out the obligation of public institutions to indemnify the purchaser or the company, as the case may be, up to the price paid for the shares or assets, as regards the damages incurred as a result of the establishment on behalf of the respective company of obligations under the environmental regulations or of liabilities due to environmental pollution by former activities, if such obligations or liabilities were not included in the terms of reference or in the public offer prospectus. The Romanian state guarantees the payment of such indemnities through the public institutions.

**II. Certificate of Budgetary Debts.** At the request of the public institutions or the privatization agent, the Ministry of Finance and the other entities which administer the state budget, budget of the State Social Securities, local budgets, and budgets of the special funds shall proceed with the preparation of a report regarding the nature and amount of the outstanding budgetary debts of the company to be privatized. Based on this report, the Ministry of Finance will issue a certificate of budgetary debts that will specify the nature and the amount of all budgetary debts at the date of the report.

It should be mentioned that the provisions regarding the certificate of budgetary debts included in the Privatization Ordinance have been amended by Government Emergency Ordinance Number 150/1999.

This is the first time that the law provides for the issuance of a certificate of budgetary debts, presenting the total debts to the state budget of a company to be privatized. Such a provision is of a high importance since the certificate may be considered as a formal statement of such debts. The law provides that the respective company will be exempted from payment of any other budgetary debt that was outstanding at the date of the report and not mentioned in the certificate of budgetary debts.

**III. Mergers, Spin-Offs, Dissolution, and Liquidation.** The legal provisions regarding such forms of cessation of the activity of companies are applicable to the companies in which the state or a local authority owns at least 50 per cent plus one vote of the share capital. Such companies shall be legally dissolved in case of failure

to pay within 60 days from the maturity date their aggregate debts (except the salary debts) if their aggregate debts exceed:

(1) One-hundred-twenty per cent of the company assets, until January 1, 2000;

(2) Eighty-five per cent of the company assets, between January 1, 2000 and August 1, 2000; and

(3) Fifty per cent of the company assets, after August 1, 2000.

**IV. Privatization Agents.** The public institutions may delegate a series of powers and rights to certain privatization agents (such as banks, investment funds, audit companies, law firms, or securities companies) that will submit report to the relevant public institutions on the performed activities.

**V. Restitution Claims.** According to the Privatization Ordinance, as amended by Law 99/1999, the companies that were privatized, or have their privatization process pending, will be compensated for the loss of any immobile property in favor of the old owner.

The state will pay an equivalent amount to the company for such loss under the condition of an irrevocable court decision in favor of the old owner. The exact amount shall be settled by direct negotiation with the companies above-mentioned.

It should be mentioned that regarding the immovable property that is indispensable for the activity of the company, the Privatization Ordinance stipulates an interdiction for the court to rule a decision in favor of the old owner regarding the restitution in kind of such immobile property. In this case, the state will pay directly to the old owner the amount representing the value of immobile property subject to the restitution claim submitted to the court.

### 4. Government Decision Number 450/1999 on Approval of Methodological Norms for the Application of the Privatization Ordinance

#### *a. External Acquisitions of Shares*

**I. Public Sale Offer.** The public sale offer of shares in a company subject to privatization should be addressed to a minimum of 100 persons that are not previously selected. As provided by the relevant securities laws, a public bid may require the approval of the National Securities Commission (NSC). This approval shall be obtained on the basis of the prospectus that is to be filed with the NSC.

The acceptance of a public bid by the investors should be unconditional and irrevocable under the conditions stipulated by the NSC. Public sale bids are to be performed only by registered brokers.

**II. Sale by Way of Equity Capital Market Transactions.** Public institutions may use the following transaction methods, in compliance with Law Number 52/1994 on securities and stock exchanges:

(1) A blocksale;

(2) A sale following a purchase offer;

(3) A sale by way of secondary placement;

(4) A tender; or

(5) Any combinations of the methods described above.

**III. Sale by Negotiation.** Generally, the sale by negotiation shall be made when the seller is exclusively addressing strategic investors. To take part in the negotiation process, a bidder shall be bound by the public institution to file a security bond in the amount between three per cent and 20 per cent of the nominal value of the share stock for sale. Security bonds paid by non-winning bidders shall be fully reimbursed within two business days from the announcement of the winner.

The negotiation commission set up by the public institution may set out that the negotiations could be carried out on the basis of preliminary and non-binding offers filed by potential buyers and on the basis of the contractual framework proposed by this commission. Subsequent to receiving the preliminary offers and any negotiation, the final draft of such contractual framework shall be drawn up and sent to all potential buyers 10 days before the deadline for submitting the final biding offers. The selected biding offers shall constitute the grounds for the final negotiation in order for the share sale purchase contract to be signed.

**IV. Sale of Shares by Tender.** The sale may be performed in two ways:

(1) By open tender; or

(2) Through a controlled auction.

To take part in the tender, the bidders should pay a participation fee.

The open tender shall be performed according to the rule of a competitive or Dutch tender, respectively at an increasing or decreasing price under the relation between demand and supply.

In a controlled tender, irrevocable purchase bids shall be filed in a sealed envelope and include, amongst other things, the name of the bidder, the offered price, and payment method.

*b. Internal Acquisitions of Shares*

The persons who may acquire shares under the privileged conditions of internal acquisitions are:

(1) The employees of the company subject to privatization;

(2) Retired employees of the company subject to privatization; or

(3) The members of the Board of Directors of the company subject to privatization.

*c. Sale of Assets*

The sale of assets which exceed, individually or in aggregate, 50 per cent of the book value of the company's assets at the date of the sale bid must be approved by the General Meeting of Shareholders. In all other cases, the sale of assets is to be approved by the Board of Administration if the statutory documents of the company do not provide otherwise.

The buyer of the asset shall acquire the plot of land related to an asset where such land belongs to the state's private property, as opposed to the case where the plot of land belongs to the state's public property, in which case it cannot be sold.

*d. Special Provisions*

**I. Concession of Land.** In the event that a state-owned company, subject to privatization, uses the land that belongs to the state's public property, such land will continue to be used by this company under a concession agreement to be concluded with the relevant authority, for a maximum period of 49 years.

**II. Environmental Issues.** Government Decision Number 450/1999 provides that the companies in which the state or the local authority holds a controlling equity interest must commence the preparation of the environmental report within 30 days after the Government Decision Number 450/1999 came into force.

Such companies must submit the environmental report for approval to the relevant environmental authority. The environmental authority may approve the environmental report or require the company to prepare and submit a more detailed environmental report.

**III. Certificate of Budgetary Debts.** Government Decision Number 450/1999 provides that the report on the nature and the amount of the outstanding budgetary debts of a company subject to privatization must be finalized within 30 days following the notification by the Ministry of Finance of the relevant regional authority in this respect.

A copy of the certificate of budgetary debts must be made available by the public institution to each potential purchaser at least eight business days before the date scheduled for the submission of the final offers.

**IV. Voluntary Cessation of Activity and Sale of the Non-Profitable Assets.** The assets of companies that in the production process do not recover the associated costs are considered as non-profitable, and therefore are subject to operational closing.

### 5. Government Decision Number 563/1999 on Approval of the Privatization Strategy for 1999

Government Decision number 563/1999, on the Approval of the Privatization Strategy for 1999 (Privatization Strategy), sets out the framework for the performance of the privatization process during 1999.

The Privatization Strategy sets out certain measures that may be required to restructure a company prior to its privatization. These measures include, without limitation:

(1) The establishment of several profit centers within the company;

(2) A split-up of the company into several companies along the lines of distinct production activities; and

(3) A merger with a similar company or companies to increase or consolidate the position in the domestic and/or export markets.

Any proposal for the modification and/or completion of the national privatization strategy can be forwarded to the government by the RDA on the request of a public institution, or a privatization agent with the approval of the relevant ministry. The approval of a new national privatization strategy or the modification of the existing one will also affect a privatization process already initiated.

It should be mentioned that in respect of Banca Agricola, Government Decision Number 563/1999 provides several objectives, including:

(1) The completion of the restructuring process started in 1998; and

(2) The initiation of the privatization process and the establishment and approval of the relevant privatization strategies. Such objectives are an integral part of the privatization policy of the banks in which the state is a majority shareholder.

## C. SPECIAL REGULATION APPLICABLE TO BANK PRIVATIZATION

### 1. Law Number 83/1997 on Bank Privatization

On May 21, 1997, the parliament approved Law Number 83/1997 on bank privatization (Bank Privatization Law). The Privatization Ordinance supplements the Bank Privatization Law to the extent it does not conflict with it.

Procedures to be used for bank privatization are:

(1) A share capital increase by private contribution in cash on the basis of public tender or private placement;

(2) A sale of shares increase, by way of up-front payment, to Romanian or foreign individual and legal entities with a majority of private capital or to international financial institutions; or

(3) A combination of the above two procedures.

A privatization commission (Commission) is to be set up for the privatization of each bank, which is empowered to supervise the privatization operations. The Commission is responsible for negotiating and arranging the sale and all associated matters.

The Governor must approve the privatization procedure decided on by the Commission. The acquisition of ownership rights in the stock of a bank under privatization according to the Banking Privatization Law is subject to the following restrictions:

(1) Shares sold by the SOF cannot be paid for by way of loans granted by Romanian banks or foreign banks operating in Romania;

(2) Similar allotments of shares cannot be paid for by way of loans granted by banks or foreign banks operating in Romania;

(3) Shares acquired with cash obtained from external credits cannot be pledged to guarantee said credits; and

(4) Romanian or foreign individuals or legal entities taking action directly or indirectly, individually or jointly, and in relationship with third parties, will not be able to acquire the ownership right on a number of shares representing more than 20 per cent of the total registered capital of a banking company under privatization according to the Law, except for the reputable international financial banking institutions.

The failure to observe any of the above-stated dispositions is deemed as breach of the banking prudential norms and is sanctioned by depriving the acquirer of the exercise of related vote rights as well as by the latter being compelled to assign, in the conditions of the Banking Privatization Law, the registered capital quota thus acquired.

The Banking Privatization Law also sets forth that the privatization of banks will be achieved on the basis of the due diligence report and the feasibility study drawn up by a specialized company selected by auction in accordance with the methodological norms.

**2. Government Decision Number 458/1997 on Approval of Methodological Norms of the Bank Privatization Law**

The Methodological Norms enacting the Bank Privatization Law were passed by Government Decision Number 458/1997, published on August 25, 1997.

These Methodological Norms set out the structure, organization, operation, and powers of Commissions set up for banking commercial companies having the state as shareholder and which are privatized on the basis of the Banking Privatization Law. The most important powers of the Commission are that it:

(1) Coordinates all the operations related to the privatization of banking companies with the conditions of the law, with observance of all the transparency, rigor, and objectivity principles;

(2) Accounts for the organization and development of auctions for selecting the specialized commercial company or firm which effectuates the estimate report and feasibility study;

(3) Elaborates the specifications within 15 days from the appointment of the privatization commission; and

(4) Initiates publicity for selection by open public auction of the specialized commercial company or firm which will achieve the estimate report on banking company and the privatization feasibility study.

Three annexes accompany the Methodological Norms, and they allow the Commission to:

(1) Regulate the organization of auctions for selection of specialized commercial company and firm to elaborate the estimate report on banking company and the privatization feasibility study;

(2) Frame the contents of specification, as elaborated by the Commission; and

(3) Design the evaluation sheet for the estimation of the technical bid.

CHAPTER 16

# ENVIRONMENTAL LEGAL ISSUES IN PROJECT FINANCE AND MERGERS AND ACQUISITIONS

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## A. ENVIRONMENTAL REVIEW OF PROJECT

Environmental legal issues are important considerations in structuring project finance and merger and acquisition transactions. These issues should be considered at the time the project transaction structure is being determined. Each transaction will involve different environmental issues. These must be determined and understood so that they can be taken into account in the transaction.

It is important to understand the nature of the business concerned, types and location of facilities involved, nature of real estate interests involved (leased and owned real property), and transaction structure (stock, assets, or financing). An environmental lawyer should be involved at the earliest possible stage to review these factors and undertake an environmental review of the business, operating facilities, assets, and real estate parcels (owned or leased).

The environmental lawyer may need to work with an environmental consultant in the course of undertaking the review. There are two basic points which need to be understood about the work of the environmental lawyer and consultant. First, the environmental lawyer should be engaged first and should make a preliminary determination about the level of environmental due diligence necessary for the transaction. Second, the environmental consultant should then be engaged after the environmental lawyer has completed his preliminary determination so that the scope of the environmental consultant work can be tailored to what is necessary for the transaction. This reduces costs and time factors. While the environmental consultant can undertake necessary field and sampling work, the consultant should let the environmental lawyer provide guidance on the legal and structural issues involved in the transaction.

It is critical that the transaction lawyers and principals permit sufficient time for the environmental issues to be assessed. In many transactions, the environmental lawyers are employed at the end of the transaction, and there is not sufficient time to

properly conduct an environmental review. Since many project finance and merger and acquisition transactions involve significant financial values and risks, failing to properly handle the environmental issues could potentially lead to legal problems and costs.

## B. TYPICAL ENVIRONMENTAL LEGAL ISSUES

While there are many environmental legal issues to watch out for in any transaction, there are some common issues which are routinely assessed. Depending on the structure of the transaction, there may be a potential for individual shareholder/officer liability depending on the nature, size, and organization of the ownership entity involved and the post-transaction degree of involvement of that entity in the operations of the business (individual participation in or control over the management of the company generally, and environmental activities in particular).

The individual shareholder/officer liability considerations should be carefully reviewed, and the law of the jurisdictions involved studied to assess the risk of the liability. It may be possible to adjust the transaction structure and avoid this problem without affecting the nature of the transaction.

After the environmental review and due diligence have been completed, the parties will likely have more information about the nature of the environmental liability and risks. Those liabilities and risks may be allocated between the parties by using a number of mechanisms in the transaction documents. Those mechanisms may include representations, warranties, covenants, indemnifications, releases, and "As Is" provisions.

Another common environmental legal issue is whether the proposed transaction will trigger environmental law notice and transfer requirements. The environmental and related laws of the jurisdictions involved should be carefully reviewed to determine whether there are any special legal requirements of this type. Typical sources of these requirements include chain-of-title restrictions, consent orders and other agreements, environmental operating and discharge permits, and laws concerning asbestos, transfer and disposal of hazardous substances, underground storage tanks and storage, and lead.

## C. SATISFYING LENDER CONCERNS AND REQUIREMENTS

As the majority of project finance and merger and acquisition transactions involve lenders, it is therefore critical that any environmental requirements of the lenders to be involved in the transaction be understood and followed. The lenders may have environmental requirements which go to the heart of the transaction.

Lenders may require "Transaction Screen and Phase I" environmental audits which are consistent with American Society for Testing and Materials (ASTM) standards. A "Phase II" environmental audit may also be required. Many lenders have their own audit policies and programs.

Lenders may also be subject to mandated environmental risk programs and guidelines. In the United States, there are several mandated guidelines which apply to banks and other lending institutions. The Federal Deposit Insurance Corporation, (FDIC), which insures bank deposits, has environmental guidelines for banks. The guidelines contain information and recommendations about implementing environmental risk programs tailored to the individual bank's loan portfolio.[1] The United States Federal Reserve and Office of Thrift Supervision have environmental guidelines which are similar to the FDIC's.[2]

The World Bank and other multinational lending institutions often have detailed environmental review procedures required as part of the lending evaluation process. There may also be environmental project criteria which must be met to qualify for the loan.

## D. UNDERTAKING AN ENVIRONMENTAL REVIEW

### 1. Review Areas of Potential Environmental Liability

A review of areas of potential environmental liability which may be involved in the transaction should be undertaken. The potential environmental liabilities will dictate the scope and manner of the necessary environmental due diligence, and provide the lawyers involved in structuring the transaction with an indication of the legal liability allocation mechanisms which may be needed for the transaction.

The following potential environmental liability allocation areas should be considered:

(1) Facility operation and regulatory compliance, e.g., emissions or discharge limitations, reporting, record keeping, or permits;

(2) Facility site-specific and surrounding area soil, surface water, and groundwater contamination;

(3) Liabilities associated with off-site disposal facilities used by the facility, business operations, associated services, and the facility's predecessors;

(4) Facility-related property damage (neighbors), occupational illness, and personal injury related to exposure to environmental contamination; and

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[1] February 25, 1993, Letter Number FIL-14-93, from Stanley J. Poling, FDIC Director to FDIC Supervised Banks.

[2] Federal Reserve's Guidance: "Environmental Liability", October 11, 1991 and *Office of Thrift Supervision's Bulletin* 16: "Environmental Risk and Liability", February 6, 1989.

(5) Diminution in facility or neighboring property value due to environmental contamination.

## 2. Conducting Environmental Due Diligence

A pre-transaction environmental site assessment (ESA) of wastes and, less commonly, environmental regulatory or operational compliance audits, are often undertaken to determine the potential for liability associated with releases of hazardous substances.

An ESA and environmental audits provide valuable up-to-date information needed to evaluate whether the particular facility or property is in compliance with environmental laws and regulations. ESA and audits serve the purpose of identifying significant environmental problems so that the problems can be dealt with in the context of the particular transaction. There are some basic considerations relating to the ESA and audits.

If environmental problems surface, the buyer or lending institution may require that the seller company clean up the contamination or bring the facility into environmental compliance on a specific time table, either before or after the closing of the transaction.

To ensure objectivity, independent consultants should perform the ESA and audits, rather than the company's in-house staff. Often, the environmental or engineering staff of the facility or business involved will offer to provide environmental information concerning the company's operations. While this information should be accepted, it should never substitute for an independent, objective environmental review.

The environmental laws and regulations of the legal jurisdictions involved in the transaction should be studied to determine whether the environmental due diligence should be structured in a particular way to qualify for available environmental legal liability protections. For example, in the United States, the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and certain state statutes contain "innocent buyer" protections. A party conducting an ESA who follows the American Society for Testing and Materials (ASTM) Transaction Screen and Phase I procedures (and in some cases, the ASTM Phase II ESA procedure), in addition to the applicable state law requirements, may qualify for the "innocent purchaser" defense.

## 3. American Society for Testing and Materials Transaction Screen and Phase I Environment Site Assessment

### a. *Guidelines*

The American Society for Testing and Materials (ASTM) has developed guidelines to provide standards for consultants, industry, local, state and federal agencies,

judiciary and other parties who will be able to refer to the standards for accepted practices and procedures accompanying a Transaction Screen and ESA.[3] It is important to note that a number of environmental issues are not covered by the Transaction Screen and ESA. Those issues not covered are: asbestos containing materials, radon, lead-based paint, lead in drinking water, and wetlands.

The Transaction Screen and Phase I provide the criteria for conducting an appropriate inquiry for the purposes of establishing CERCLA's innocent purchaser defense. These procedures are intended to provide an approach for determining whether "recognized environmental conditions" exist with respect to a commercial property. If "recognized environmental conditions" exist, a Phase II ESA is necessary to establish the "innocent purchaser" defense.

*b. Mechanics of the Transaction Screen*

The Transaction Screen requires that specific steps be followed to obtain environmental information about a facility or site. People completing the Transaction Screen (who do not need to be environmental professionals) are given a checklist of:

(1) Questions to ask owners and occupants of the facility or site;

(2) Observations to make about physical conditions at the facility or site; and

(3) To the extent reasonably ascertainable, a limited research of available government records and certain standard historical sources which may have environmental information regarding the facility or site.

*c. Mechanics of Phase I*

Phase I must be completed by an environmental professional and contains a prescribed checklist of procedures to follow. These procedures are summarized as:

(1) A review of regulatory records;

(2) A site reconnaissance, i.e., a visit to the property;

(3) Interviews with current owners and occupants of the property; and

(4) Interviews with local government officials.

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[3] Transaction Screen Process E 1528-96, adopted in 1993 and revised in 1996 under the jurisdiction of Committee E-50 on Environmental Assessments; Phase I Environmental Site Assessment Process E 1527-97, adopted in 1994 and revised in 1997 under the jurisdiction of Committee E-50 on Environmental Assessments. Both are ESAs for commercial real estate.

*d. Mechanics of Phase II*

The Transaction Screen and Phase I are not intrusive environmental evaluations because they do not require environmental sampling. The information developed from the Transaction Screen and Phase I may call for intrusive sampling, and a sampling plan and approach must be developed for the facility or site. While it is difficult to develop a standardized procedure, since each facility or site has different environmental issues, the ASTM has developed a standard procedural guidance for these "Phase II" sampling investigations. In 1998, ASTM Committee E-50 on Environmental Assessments finalized its E1903-98 guide for Phase II investigations, entitled "Standard Guide for Environmental Site Assessments: Phase II Environmental Site Assessment Process".

The ASTM Phase II is intended as a guide for conducting an investigation of "recognized environmental conditions" identified during a Phase I or Transaction Screen. The ASTM developed the guide to assist the user in gathering sufficient data about the nature and extent of contamination at a property to make an informed transaction-based decision and, in certain cases, to obtain the level of knowledge necessary to determine that hazardous substances have not been disposed of or released at the property, thereby satisfying CERCLA's innocent purchaser defense.

The Phase II does not assess the legal risks associated with a transaction where hazardous substances or petroleum products are present at *de minimis* levels. In such cases, it is unclear whether the "innocent purchaser" defense is available.

After Phase II is completed, the environmental professional should be able to conclude that either: the ESA has provided sufficient information to determine that there is no reasonable basis to suspect the presence of hazardous substances or petroleum products at the property with respect to the "recognized environmental conditions" under investigation, or confirmation of the presence of hazardous substances or petroleum products at the property.

A Phase II ESA is, by its nature, site and transaction specific. Thus, the ASTM Phase II is not as standardized as the ASTM Transaction Screen or Phase I. The level of the assessment will vary depending on the needs of the user and the business situation driving the ESA. The general outline of Phase II include the following steps:

(1) The development of work plans — The methods and work tasks necessary to achieve the user's Phase II objectives must be determined. The person designing Phase II should consider site limitations, existing site information, the potential distribution of contaminants, sampling plans, health and safety plans, chemical testing plans, quality assurance, and quality control procedures;

(2) The determination of site assessment activities — The actual field sampling protocols must be determined. These protocols include field screening and field analytical techniques, environmental media sampling, and sample handling;

(3) The evaluation of sampling data — The field sampling date must be evaluated. The evaluation should include the verification of sampling protocol assumptions and data;

(4) Interpretation of results — The results of Phase II investigation should be interpreted to eliminate or confirm "recognized environmental conditions"; and

(5) Phase II ESA Report Preparation — The findings and conclusions of Phase II should be presented in a specified report format.

## E. SPECIAL CONFIDENTIALITY AND PRIVILEGE ISSUES RELATED TO ENVIRONMENTAL AUDITS

### 1. Background

It is important to consider available confidentiality and privilege protection when designing and conducting environmental reviews. The availability of these privileges and protections varies depending on the jurisdictions involved in the transaction, but they need to be considered carefully by the environmental and transaction lawyers.

In the United States, the three privileges potentially applicable to environmental audits are attorney-client, work product doctrine, and self-critical analysis privileges. These privileges permit the privilege holder to shield information from disclosure to governmental entities and third parties. However, the holder must meet specific criteria to take advantage of these privileges.

### 2. Attorney-Client Privilege

The attorney-client privilege enables a client to preclude disclosure, either by the client or through the client's attorney, of a communication made by the client to the attorney, in confidence, for the purpose of obtaining legal advice, unless and until that privilege is waived by the client.[4] Application of the privilege is determined on a case-by-case basis. The privilege has been applied to environmental audits. In *Olen Properties Corp. v. Sheldahl Inc.*,[5] an environmental audit report prepared by a company's internal environmental affairs personnel was protected by the attorney-client privilege because it had been "prepared for the purpose of securing an opinion of law" from the company's counsel. The privilege does not shield the client from answering questions regarding the violation itself, nor does it eliminate any otherwise applicable reporting requirements.

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[4] See Upjohn Co. v. United States, 449 U.S. 383 (1981).

[5] Olen Properties Corp. v. Sheldahl Inc., 1994 W.L. 212135 (C.D. Calif. 1994).

### 3. Work Product Doctrine

The work product doctrine exempts from the doctrine of discovery, materials that are prepared in anticipation of litigation or for trial, unless the party seeking discovery of the materials demonstrates that it has a substantial need for them and is unable without undue hardship to obtain the substantial equivalent of the materials elsewhere.[6]

In certain respects, the work product doctrine is broader than the attorney-client privilege because it covers information beyond the client's confidences, such as information from third parties. However, it is limited to situations where litigation is pending or anticipated. Of course, environmental reviews often involve matters that are or are anticipated to be the subject of litigation.

### 4. Self-Critical Analysis Privilege

The self critical analysis privilege is a qualified privilege recognized under certain case law which protects from discovery certain critical self-appraisals which could be used against the company by its opponents in future litigation.

### 5. Environmental Audit Privilege Statutes

There has been a substantial effort made in the United States to encourage companies to conduct environmental audits and correct environmental compliance problems without fear of disclosure of the audit results to third parties and potential legal penalties. At least 20 states in the United States have enacted some type of audit privilege legislation.

The basic characteristic is that this type of legislation provides a shield against disclosure and offers full or limited immunity for violations detected, reported, and corrected. In the United States, several state statutes grant a limited privilege against disclosure of environmental audit reports and supporting materials. Some state statutes also grant partial or total immunity from prosecution of violations uncovered by an audit where the violation was promptly disclosed. No state statute offers any type of immunity for private tort actions. The holder must pursue a diligent effort to achieve compliance within a reasonable amount of time. Immunity is unavailable if there is a pattern of non-compliance.

The statutes prevent protected information from being subpoenaed or discovered in any proceeding. However, a state's prosecutor may obtain otherwise privileged environmental audit information if he can show a need for the information and an inability to procure it from other sources without undue expense. In general, privileged materials include the audit report itself as well as information collected or developed for the audit report, memoranda discussing the report, plans

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[6] Fed. R. Civ. P. 26(b)(3).

for corrective action, and other documents that arise out of the audit process. Some statutes require that documents include a legend such as "Environmental Audit Report: Privileged Document".

The underlying facts of the violation are not privileged, and the privilege does not cover information required by law to be reported, i.e., sampling data. Nor does the privilege apply to willful or reckless acts or situations of an impending serious danger to health or to the environment. Generally, the privileges afforded by the state audit statutes are unavailable in most state actions and in federal actions based on federal claims.

In the United States, the United States Environmental Protection Agency (USEPA) opposes state audit privilege laws and has gone on record stating this opposition and reserving its right to obtain audit reports in appropriate cases.[7] However, the USEPA has developed its own environmental auditing policy in an effort to encourage companies to conduct environmental audits without fear of penalties. The USEPA policy does not provide complete protection to a company conducting environmental audits from USEPA penalties.

### 6. United States Environmental Protection Agency (USEPA) — Environmental Auditing Policy

In 1995, the USEPA issued its policy on environmental auditing entitled "Incentives for Self-Policing; Discovery, Disclosure, Correction and Prevention of Violations".[8] The policy provides incentives for self-policing. The USEPA will waive gravity-based penalties (non-economic) for violations found through either an auditing program, or a documented procedure for self-policing where the company can show that it has a compliance management program that meets the USEPA definition of due diligence. The USEPA reserves the right to collect any economic benefit that may have been realized as a result of non-compliance but may waive the economic benefit if it determines that the benefit is insignificant.

The USEPA also reaffirmed its policy to refrain from routine requests for audits. However, if the USEPA has independent evidence of a violation, it may seek information needed to establish the extent and nature of the problem and the degree of culpability.

In addition, the USEPA will not recommend criminal prosecution for a regulated entity which discovers violations through environmental audits or due diligence and meets all nine conditions set forth in Part D of the Policy. This policy

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[7] State Audit Privilege Laws and Legislation, Internal USEPA Policy Memo From Nancy K. Stoner, November 10, 1997.

[8] USEPA, "Incentives for Self-Policing; Discovery, Disclosure, Correction and Prevention of Violations", 60 Fed. Reg. 66, 706 (1996), effective January 22, 1996.

will not apply where corporate officials are consciously involved in or willfully blind to violations or conceal or condone noncompliance.

For regulated entities which discover a violation outside of an environmental audit and who do not have a due diligence program, the USEPA will reduce the gravity-based penalties by 75 per cent if the regulated entity meets certain conditions set forth in Part D of the Policy.

The difficulty with privilege and confidentiality protections relating to environmental audits is that they may be overridden by full disclosure requirements contained in the transaction documents. Often, environmental representations and indemnities require full disclosure of environmental conditions at a facility or site. Even if previously conducted audits are protected under available privileges and confidentiality protections, the information developed by those audits will not be. This fact must be considered up front when the project finance and merger and acquisition transaction is in the planning stage.

# CHAPTER 17
# EUROPEAN ENVIRONMENTAL LAW — PUBLIC AND MAJOR PROJECTS

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## A. INTRODUCTION

This chapter will explain rights which the public and citizens' groups are increasingly being given in the decision-making and judicial process of major projects, and also to analyze the effects on consenting to major projects. In dealing with this issue, one also must bear in mind the political influence of interest groups such as Greenpeace and Friends of the Earth, e.g., their influence in decision-making on Brent Spa, England.

Furthermore, where controversial development is involved, there is a willingness by some members of the public to take direct action, examples being those living in trees and tunnels by Manchester Airport and the Newbury by-pass. The capacity of the public to delay or frustrate a project by judicial, political, or direct action therefore needs to be addressed.

## B. THE ROLE OF THE PUBLIC

One feature of European environmental law is that the public is increasingly given a major role in being able to influence whether a project proceeds. In reality, the public's rights are two-fold, namely:

(1) Involvement in the decision-making process, i.e., the right to be consulted whether a permit is issued; and

(2) The right to complain in the courts if there are defects in the consent process.

The effects of these public rights on a project are two-fold, namely:

(1) Longer lead time for the project; and

(2) Uncertainty while the legality of the decision-making process is being challenged.

The public's rights in the development control process until recently have been a matter for national legislative systems. However, European Union (EU) law has consolidated the public's right to consultation. A few examples are:

(1) The Environmental Assessment Directive envisages that the public will be informed usually by bill-posting within a certain radius, publication in local newspapers, organization of exhibitions, consultation by written representations, or by public inquiry;[1]

(2) A project affecting a designated habitat should, if appropriate, be the subject of public consultation before consent is given;[2] and

(3) Applications for permits for new installations of substantial changes to existing installations subject to IPPC must be made available for an appropriate period of time to the public to enable it to comment on them before the competent authority reaches its decision.[3]

## C. LEAD TIME

Public consultation (which may include a public inquiry) has added to the lead time of major projects. In England, the public inquiry into the extension of Heathrow Airport by adding a new terminal, Terminal Five, lasted 524 sitting-days and took three years. Added to this time is the process before the inquiry is actually set up and the post inquiry process, which will consist of the Inspector writing a report summarizing all the sitting-days and a consideration of that report by the Minister.

It is true that the experience of Heathrow Airport is a one-off. However, public inquiries which have lasted more than 180 sitting-days include Stansted Airport and two public inquiries for new nuclear power stations.

## D. JUDICIAL SUPPORT

The European Court of Justice has made it difficult for local interest groups to apply directly to that court alleging a breach of EU law.[4] However, pointers have been given that national courts should give effect to European Community (EC) rights. The Advocate General has said that EC law which, directly or indirectly, gives effect to the EC's environmental objectives, has favored individuals by creating certain specified rights of real substance, which are guaranteed by the national and EC judicial authorities. Those rights, as a general rule, flow from the direct

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1 European Community Directive 85/337/EEC, as amended by 97/11/EC, article 6(3).

2 European Community Directive 92/43/EEC, article 6(3).

3 European Community Directive 96/61/EC, article 15(1).

4 Stichting Greenpeace Council v. European Commission [1998] All E.R. (EC) 620.

effect of Directives whose subject matter is concerned with environmental protection.[5] Examples were given of the Italian World Wildlife Fund's challenge in respect of hunting and the challenge by the Royal Society for the Protection of Birds in the *Lappel Bank* case. The Advocate General acknowledged that individuals could secure the possibility of seeking judicial assistance in conserving the environment, even where such a right is not provided for directly and expressly by the EC legislature.[6] The European Court of Justice is conscious that the utility of a Directive would be weakened if individuals were prevented from relying on it before their national courts.[7]

It would be wrong to gain the impression that every breach of European environmental law would entitle objectors' groups to challenge the decision in the courts. In Italy, objectors sought to argue that article 4 of the Waste Framework Directive conferred on an individual's rights which the national courts must safeguard. Article 4 provided that Member States should take necessary measures to ensure that waste was disposed of without endangering human health and without harming the environment.

The European Court of Justice reaffirmed that, wherever the provisions of a Directive appear, as far as their subject matter is concerned, to be unconditional and sufficiently precise, those provisions may be relied on by an individual against the state where the state fails to implement the Directive into national law by the end of the period prescribed or where it fails to implement the Directive correctly. The ECJ, however, held that article 4 was neither unconditional nor sufficiently precise and therefore was not capable of conferring rights on which individuals may rely as against the state.[8]

## E. COMPLAINTS TO THE COURT

Most western European countries have a system in which the administrative decisions taken by national and municipal authorities can be challenged on the grounds of illegality. In England, such challenges are made by judicial review. For some time now, judicial review action has been taken by objectors to seek to prevent or delay a project from proceeding. The prospects of such challenges is particularly important in respect of project finance. Banks are unlikely to lend money where there is a serious risk of judicial review action.

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[5] Stichting Greenpeace Council v. European Commission [1998] All E.R. (EC) 620, at p. 639.

[6] Stichting Greenpeace Council v. European Commission [1998] All E.R. (EC) 620, at p. 640.

[7] Aannemersbedrijf P K Kraaijeveld BV and Others v. Gedeputeerde Staten van Zuid-Holland [1997] All E.R. (EC) 134 (Case C–72/95).

[8] Comitato di Coordeinamento per la Difesa della Cava v. Regione Lombardia, I–483, Case C–236/92.

Where a project is not so financed, the developer may take the risk to proceed with the development in spite of judicial review action. This can happen where the project is financed by the public sector. It is significant that the Port of Sheerness proceeded with its extension despite the judicial review proceedings being undertaken.

In preparing a case to go to court, objectors will be able to obtain information on the environment held by public bodies.[9] There are limited exceptions where objectors under European environmental law can obtain any available information in written, visual, aural, or data-based form on the state of water, air, soil, fauna, flora, land, and natural sites and on activities (including those which give rise to nuisances such as noise) or measures adversely affecting or likely so to affect these, and on activities or measures designed to protect these, including administrative measures and environmental management programs. Objectors denied that such a request may seek a judicial or administrative review of the decision in accordance with the relevant national legal system.

If judicial review action is taken, then there could be a serious delay to the project. In England, an applicant needs to obtain permission to apply for judicial review by a judge. If that permission is refused, then an application may be further made to the Court of Appeal. If permission is granted, then the matter will be determined by a judge after full argument. If the action is successful, then the decision is remitted to the decision maker (usually the Minister of the local authority), who is then directed to remedy the defect in the decision-making process and come to a decision afresh. There is no guarantee that the original decision to consent to a project will be re-affirmed.

One of the advantages which objectors have is surprise. Objectors are consistently seeking to make new law or extend existing law. As a result, it is not always easy to predict what points will be taken. Furthermore, if laden with sufficient funds, objectors can create difficulties for the project in the courts. An example of such difficulties is provided in the cases involving challenges by Greenpeace to the nuclear reprocessing plant at Sellafield. Greenpeace first sought a stay of a variation of a radioactive pollution authorization to prevent testing taking place: that application proceeded to the Court of Appeal but failed there.[10] Greenpeace then pursued its objection to the testing authorization in the court.

Although it failed, this was one of the first cases establishing that interest groups like Greenpeace would normally be heard in the courts and would be afforded the necessary status to be a party.[11] Greenpeace then challenged the grant of the authorizations for the main process in the courts on the grounds that there had

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[9] European Community Directive 90/313/EEC on the freedom of access to information on the environment.

[10] R v. Inspectorate of Pollution ex p Greenpeace [1994] 4 All E.R. 321.

[11] R v. Inspectorate of Pollution ex p Greenpeace (Number 2) [1994] 4 All E.R. 329.

been a breach of the appropriate Euratom Directive (80/836) and that there had been a breach of the Environmental Assessment Directive.[12] Despite losing that case, Greenpeace established under English law that the release of radioactive substances should be justified by sufficient benefit to offset the radiation detriment.

Project agreements therefore need to take into account the possibility that consents may be challenged by judicial process. An understanding needs to be acquired in any project about the likelihood of such challenge and how such challenges could be made. For example, in England, consents can usually only be challenged in a period of three months and, even then, the challenge must be made promptly within that period.[13]

As a result, one can be almost certain if a challenge is not made within the three months that the project may go ahead. Where the fixed time has passed, then banks may usually safely allow draw-down. However, other countries, such as Scotland do not have a fixed time frame in which judicial review action may be taken. For projects in such countries, the possibility of judicial review action will presumably fade as to times goes by, but there may be a residual risk. That residual risk will need to be assessed.

## F. ENVIRONMENTAL ASSESSMENT

The requirements for environmental assessment are now well established both in EU law and also in national systems. However, those promoting major projects need to be aware that the requirements of this Directive have been used on several occasions as a basis for challenging a decision to allow a project to go ahead.

One of the first times in which European law was used to challenge a decision to allow development to go ahead in England was the M3 motorway case in which the validity of the proposal to extend the M3 motorway through Twyford Down was considered. In that case, the challenge was rejected by the courts on grounds which may well not have stood the test of time.[14] The *Twyford* case is an important example of a motorway being slowed down as a result of action in the courts and direct action by members of the public.

Since then, there have been a number of cases both in England and Europe in which objectors have sought to frustrate projects on the grounds that an environmental assessment has not been carried out. A plan by a Dutch local authority to reinforce the dykes in its area without proper consideration of environmental effects of the constructional work involved was the subject of a successful challenge. In that

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[12] R v. Secretary of State for the Environment ex p Greenpeace [1994] 4 All E.R. 352.

[13] Civil Procedure Rules 1998 Schedule 1 RSC Order 53. Permission may be granted for an action outside the three-month period, but that is a rare occurrence.

[14] Twyford Parish Council v. Secretary of State for the Environment [1992] 1 C.M.L.R. 276; (1992) 4 J.E.L. 273.

case, the criteria/thresholds had been set at such a level that, in practice, all projects relating to dykes would be exempted in advance from an impact assessment. The court held that a Member State could not establish criteria thresholds at a level such that, in practice, all projects relating to dykes would be exempted in advance from the requirement of an impact assessment — that would exceed its limits of expression under the Directive unless all projects excluded could, when viewed as a whole, be regarded as not being likely to have significant effects on the environment.[15]

Further challenges have concerned power stations. There was an attempt in Germany to get around the requirement for an environmental assessment of a power station of over 300 megawatts on the basis that it was an extension of an existing station. The European Court of Justice held that such projects must be assessed irrespective of whether they are separate constructions, are added to a pre-existing structure, or even have close functional links with a pre-existing structure. Links with an existing structure do not prevent the project from being a thermal power station with a heat output of 300 megawatts or more so as to bring it within the category of modifications to Annex 1 projects.[16]

Not so long ago, the proposal for the setting up of a parcel facility adjacent to Coventry Airport was the subject of a court challenge by local objectors.[17] The size of the facility was below all the criteria which had been set by national governments as to whether environmental assessment should be ordered. The local authority did not require an environmental assessment. Objectors sought a ruling from the government that environmental assessment was required.

The government endorsed the local authority's view but did not give reasons. The lack of reasons supporting the government's view was the subject of challenge in the courts. The case went through the three tiers of the English courts. Both the High Court and the Court of Appeal endorsed the Secretary of State's approach, and the House of Lords, without giving reasons, decided not to hear the appeal. In that case, the developer proceeded with the project despite the court action. As a result, when the case came before the House of Lords, the project was under construction.

This case is one of many which illustrates how objectors will make use in the national courts of EU law to seek to frustrate a project which has been endorsed by national authorities. Had the project concerned been underwritten by the banks, there could have been a delay of one and a half years for the matter to be sorted out. That period would have lengthened if the House of Lords had acceded to the objector's request to refer the matter to the European Court of Justice for determination.

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[15] Aannemersbedrijf P K Kraaijeveld BV and Others v. Gedeputeerde Staten van Zuid-Holland [1997] All ER (EC) 134 (Case C–72/95).

[16] European Commission v. Germany, Case C–431/92 [1995] E.C.R. I–2189.

[17] R v. Secretary of State for the Environment ex p Marson [1998] J.P.L. 869.

## G. CONSENTING PROCEDURES

There is now a clear trend under European environmental law for similar procedures being used to consent to projects in Member States. Increasingly, the public is being given a role in the consenting process.

Major projects should have a development consent and, in many cases, a pollution consent as well. As a result of amendments to the Environmental Assessment Directive, a development consent (in England, a planning permission) must be granted for a major project. As the Directive envisages that the public should be consulted, the courts will give the public the right to challenge the decision if the requirements of the Directive are not complied with.

The Directive on integrated pollution, prevention and control, similarly establishes the need for permits to be issued in accordance with the Directive.[18] The public is again entitled to comment on the application. As a result, certainly in English courts, the public will have a right to challenge the grant of a permit on the basis that the requirements of the Directive have not been met.

Similarly, the establishment or undertaking carrying out specified operations must obtain a waste permit covering the types and quantities of waste, the technical requirements, security precautions to be taken, disposal site, and the treatment method.[19] Each Member State must have a competent authority to be responsible for the implementation of the Waste Directive. Furthermore, as a result of the Landfill Directive, one may expect common provisions relating to applications, conditions, permits, and monitoring and control.

## H. HABITATS

Many of the environmental laws introduced by the EU have concerned procedure. However, the Habitats Directive broke new ground in providing protection which would be difficult for a national government to overrule.

The Habitats Directive built on the ground prepared by the Birds Directive in providing for the designation of special areas of conservation to complement the protection given to areas for birds known as special protection areas. What the Habitats Directive did was to make development much more difficult in designated areas. The Habitats Directive provided for an assessment of the implications for the site to be made where development was proposed and, normally, that would be a conventional environmental assessment.

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[18] European Community Directive 96/61/EC on Integrated Pollution Prevention and Control.

[19] European Community Waste Framework Directive 75/442/EEC, amended by 91/156/EEC.

In the case of an environmental assessment, it is always open to the planning authority to grant consent despite the negative assessment. In the case of special protection areas and special areas of conservation, it will be more difficult. The Directive provides:

(1) National authorities shall agree to the plan or project only after having ascertained that it will not adversely affect the integrity of the site concerned;

(2) In the case of a negative assessment, the plan or project can only be carried out for imperative reasons of overriding public interest, including those of a social or economic nature, in which case all compensatory measures necessary to ensure the overall coherence of Natural 2000 must be protected; and

(3) Where the site concerned hosts a priority of natural habitat type and/or a priority species, the only considerations which may be raised are those relating to human health or public safety, the beneficial consequences of primary importance for the environment or, further, to an opinion from the Commission itself, to other imperative reasons of overriding public importance.

It will immediately be seen that the designation of such an area could frustrate a project or, as a result of the compensatory measures necessary, render the project more expensive to carry out than originally envisaged.

The cases concerning the Habitats and Birds Directives show how seriously local amenity groups can be treated in the national courts and how far they can use national judicial procedures to upset a project. The European Court of Justice has not been slow to lend its protection to such areas.[20]

A leading European case concerned Lappel Bank.[21] This involved a decision not to include 22 hectares known as Lappel Bank in the Medway Estuary Marshes as a special protection area. The Secretary of State decided to exclude that area from the SPA as it was required for the expansion of the Port of Sheerness. This decision was challenged by the RSPB on the basis that the Secretary of State was not entitled to have regard to economic considerations when classifying an SPA. The European Court of Justice endorsed that view and held that a member state is not authorized to take into account economic requirements when designating an SPA and defining its boundaries.

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[20] Commission of the European Communities v. Kingdom of Spain, Case C—355/90, where the Court castigated the government for not classifying the Santona Marshes as a special protection area.

[21] R v. Secretary of State for the Environment ex p RSPB, Case C–4495.

This was in some respects a "pyrrhic" victory. The RSPB asked for an injunction to prevent development going ahead pending the ruling by the European Court of Justice. The House of Lords refused to give an interim injunction because the RSPB would not give an undertaking as to damages, i.e., reimburse the port authority if the European Court of Justice ruled that the exclusion of the area was proper. The lack of an interim judgment meant that the development could go ahead.

A further impact of the Habitats Directive concerns its effect on oil and gas in the continental shelf outside the 12-mile limit of United Kingdom territorial waters. The United Kingdom government had applied the Habitats Directive to United Kingdom territorial waters only. On a challenge by Greenpeace, the court held that the geographical scope of the Habitats Directive extended beyond territorial waters. In exercising his licensing functions for oil and gas expiration, the Secretary of State was criticized for not meeting his responsibilities under the Directive towards cetaceans, whales, porpoises, dolphins and coral in the Atlantic frontier.[22]

## I. FUTURE PROPOSALS

The European Commission has failed to bring forward a Directive on access to justice in environmental matters despite being heralded in the fifth environmental action program (1993). However, gradually, there is developing acceptance of the principle that members of the public may go to national courts to enforce European Community environmental law where such law expressly or grants them implied rights. In the future, one can expect many more challenges to the grant of permits on the basis that community environmental law has not been applied.

New proposals have sought to provide a role for interest groups. For some time now, there have been movements in the EU for a code on environmental liability. A draft White Paper has been published, and it is envisaged that, eventually, consideration will be given to legislation establishing a community environmental liability regime. The objectives of the scheme would be:

(1) To implement the "polluter pays" principle and the prevention and precautionary principles;

(2) To ensure that monies raised through liability are used for effective restoration of the environment;

(3) To strengthen the implementation of community environmental legislation; and

(4) To reduce distortions in the internal market.

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[22] R v. Secretary of State for Trade and Industry ex p Greenpeace, *The Times*, January 19, 2000; ENDS Report 299, at p. 54. R v. Secretary of State for Trade and Industry ex p Greenpeace [1998] Env LR 415.

The White Paper recommends enhanced access to justice in environmental damage cases, with primary responsibility for ensuring restoration generally resting on the Member State and interest groups which meet certain criteria having a subsidiary right to bring legal actions, but with those groups having direct access to the courts for injunctions and preventive actions in urgent cases.

## J. HUMAN RIGHTS LAW

Environmental lawyers are increasingly looking to the European Convention on Human Rights and Fundamental Freedoms for first providing a legal basis for challenging projects in addition to EU and national law. In England, the forthcoming incorporation of the Convention as part of national law is providing an increased impetus to this movement.[23] The rights provided by the Convention are already providing grounds for challenging projects from going ahead. The important articles are:

(1) Article 8 (the right to respect private and family life, home, and correspondence);

(2) Article 1 of Protocol 1 (the right to property);

(3) Article 6 (the right to a fair and independent hearing); and

(4) Article 13 (the right to an effective national remedy).

There are two areas in which judicial challenges based on convention rights could have an effect on projects. These are:

(1) Compulsory purchase procedures. A case from Sweden has already shown that prolonged compulsory purchase procedures (as is the case often in England) can cause blight and, if no adequate remedy is given, there could well be claims made that the compulsory purchase was unlawful.[24]

(2) Projects promoted by national and municipal authorities, where the ultimate decision to grant the authorization rests with such authorities, may be susceptible to judicial review on the basis that there was no independent hearing.[25] The existence of a possibility of judicial review of that decision may be sufficient to remedy any defect in the decision-making process. However, where the state acts as prosecutor, judge, and jury in promoting, say, a road project, there is, at the moment, no decided case law indicating that such procedures are lawful and proper.

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[23] Human Rights Act 1998.

[24] Hakannson and Sturesson v. Sweden (1991) E.H.R.R. 1.

[25] Bryan v. United Kingdom [1996] J.P.L. 386.

## K. MANAGING THE PROCESS

Those involved in promoting and financing major projects ignore the rights of the public at their peril. Increasingly, under domestic and EU law, the public are given rights to be involved in the decision-making in the decision-making process. Not only may this right add to the lead time of the project; there is also the corresponding possibility of challenge in the courts on the decision on the basis that national or EU law has not been followed. This risk cannot be eliminated but it can be managed, and the following suggestions are put forward in this regard:

(1) Assuring voluntary public consultation;

(2) Ensuring that correct procedures are followed;

(3) Ensuring appropriate protection is written in the contract for the possibility of judicial challenge; and

(4) Having a flexible lead time and being aware of the possibility of a judicial challenge.

# CHAPTER 18
# WATER AND WASTEWATER RESOURCE AND INFRASTRUCTURE MASTER PLANNING, FINANCING, AND CONFLICTS

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## A. INTRODUCTION

In the next 20 years, US $117 billion will be spent on wastewater infrastructure in the United States alone; worldwide, the anticipated costs over this period are expected to exceed US $1 trillion.[1] An additional US $138 billion will be spent on potable water infrastructure in the United States during the same period; worldwide, these anticipated costs should exceed another US $1 trillion.

While these figures appear staggering, they do not reflect acquisition of water resources, irrigation systems, raw water projects, flood control projects, or soft costs. Rather, they are capital costs which are needed for the replacement of aging infrastructure, meeting new regulatory criteria, and servicing the needs of an increasing world population.

In this century, the most serious singular threat to and test of world and business leaders is the future planning of a growing world water scarcity and demand for wastewater treatment. Currently, a half billion people suffer from a scarcity of water and an estimated one billion suffer from unsafe drinking water supplies. Two out of the world's six-billion people suffer from inadequate wastewater infrastructure systems. The task of planning for and meeting the demands of the estimated increase in the world population from six billion to nine billion over the next 25 years will strain the limits of our capabilities to plan, finance, and develop water and wastewater infrastructure.

As daunting as these statistics are, they do not encompass how we treat the resource itself. They do not encompass the massive costs and complexities of

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[1] Environmental Protection Agency, Clean Water Act Needs Survey (1996) (reporting to Congress the requirements for meeting sections 205a and 516(b) 1 of the Clean Water Act, 33 United States Code, sections 1251–1387 (1994).

acquiring, developing, and transferring water to use. They also do not address the complexities, costs, and timing of resolution of water allocation conflicts.

## B. RESOURCE CONFLICTS

### 1. Natural Resource

Water is the most precious and irreplaceable of natural resources. It has no substitute and is required by all living things. Unlike all other natural resources, an alternative natural resource does not exist and abstention is not an option. It is no surprise, then, that the allocation and ownership of water and its use within infrastructure projects gives rise to conflicts, for every utility that seeks to satisfy the demands of an area must secure the resource, which is only one component of the infrastructure for both water and wastewater utilities and projects.

Competition for available supplies in many regions has become intense. The right to divert groundwater or surface water supplies for use within a water utility (or reuse treated wastewater) is traditionally a purely local matter. In the United States, it is a matter for each state to establish a legislative basis for water use and ownership. Internationally, it is a matter for treaty or conflict.

There are many that believe that the brewing Middle East conflict will not be based on ideology or religion, but on water. Tensions persist over the Jordan River and its tributary, the Yarmouk, between Israel and its neighbors, Syria, Jordan, and the Palestinian territories. Conflict over this tight watershed has been a long standing source of friction which has exacerbated Middle Eastern tensions.[2] While the situation between Israel and Jordan over water has been increasingly vocal, there has been recent progress in defusing the conflict.[3] In 1994, Israel and Jordan signed an Agreement in which Israel agreed to deliver, unimpaired, 55 million cubic meters of water to Jordan.

Due to a severe drought cycle during 1998–1999, Israel announced that it would be reducing the amount of water it would deliver to Jordan by half, under its interpretation that the 1994 Agreement was inapplicable during drought or extraordinary water years. It was not until a near break in relations that Israel relented and

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[2] Many shared river basins have conflicts over the issue of resource efficiency and beneficial use. The World Bank states that the Middle East and Africa have freshwater resources of only 1,250 cubic meters per person per year compared to North America having 18,742 per person per year. By 2025, the amount of water available per person will be less than half of what it is today. Israeli water users consume 344 cubic meters per capita per year while the West Bank and Gaza Strip only consume 93 cubic meters per capita per year. This reveals the cultural perceptions of water use and misuse that often cloud allocation talks, as in the case of the United States and Mexico over the use of the Colorado River.

[3] See "Middle East Water Woe Can Only Get Worse", *Jane's Intelligence Review*, November 1, 1999, available in 1999 WL 8946036; Country Report Jordan, *The Economist Intelligence Unit Limited*, November 1, 1999, available in 1999 WL 29343416; Water Special Report, *MEED Weekly Special Report*, January 28, 2000, available in 2000 WL 7136548.

agreed to deliver the entire 55 million cubic meters to save the 1994 treaty. In an effort to reconstruct goodwill, Israel allowed Jordan to take water directly from the Jordan River as opposed to its practice of first storing water in Lake Tiberias.

This guarded cooperation underscores the fragile balance that is maintained in a shared river basin. The issue of water is one of the focal points of the Palestinian/Israelis talks, as Israel has already made it very clear that it will resist any pull back that requires it to yield its water sources from the Golan Heights.[4]

Basin-wide allocation and management proves to be difficult in any tightly shared watershed that crosses international boundaries. Couple the normally difficult process with distrust, centuries of conflict, and the twin goals of equitable utilization and equitable apportionment, and the allocation continues to be allusive.[5]

In addition to the age-old dispute over the Jordan River, the greatest danger to peace in the region, and corresponding increase in infrastructure finance risk, is the tinder box: the Euphrates. Turkey controls over 90 per cent of the watershed on which Syria and Iraq are vitally dependent. The Southeast Anatolia Project (GAP)[6] in Turkey is a case study in the coming conflict in international river basin allocation and infrastructure conflicts. Turkey is impounding the Euphrates, which is the only perennial river that traverses Syria and which is the life blood of Iraq.

When Syria and Iraq protested, Turkey responded that water was a Turkish national natural resource just like oil and, since Turkey did not attempt to tell Iraq what it could do with its oil, neither could another country tell Turkey what to do with its water. Such fervent responses have led to open conflict. In 1989, Syria shot down a Turkish survey plane in a confrontation over the Euphrates. In January 1990, Turkey virtually halted the flow of the Euphrates for nearly a month while the *Ataturk Dam* filled.

Tensions between Turkey, Syria, and Iraq rise with the sequential development of GAP. As each new dam comes online, the protests from Syria and Iraq become

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[4] Since the Six Day War of 1967, the strategic nature of the Golan Heights has been largely perceived to be strictly military, when it is in fact more complicated. The Golan Heights is critical for ensuring Israel's control and access to the Jordan River and access and control of the Yarkon-Taninim West Bank freshwater aquifer.

[5] Equitable utilization is defined as the fair, reasonable, and efficient use of water for specific beneficial uses, to be applied on a uniform basis between competing users. Equitable apportionment is defined by the United States Supreme Court in Kansas v. Colorado, 206 U.S. 46, 118 (1907), where the Court allowed Colorado to continue taking a larger share of the waters of the Arkansas River than Kansas. The Court explained that to achieve equitable apportionment, it had to "consider the effect of what has been done on the conditions of the respective States and so adjust the dispute on the basis of equality of rights as to secure as far as possible to Colorado the benefits of irrigation without depriving Kansas of the like beneficial effects of a flowing stream".

[6] Guneydogu Anadolu Projesi (GAP).

amplified. While there are two treaties allocating water within the Mesopotamian basin,[7] these agreements often are strained, e.g., Turkey asserts it has been providing an average of 700 cubic meters in compliance with the accords, but deliveries have not been consistent or to the seasonal timing satisfaction of its neighbors.

The tensions over GAP's operational effect on Syria and Iraq will only increase as Turkey's goal is to expand its irrigation ten-fold over the next 10 years. In the past, the conflict was so great that the World Bank refused to advance any funds for the project, yet Turkey went forward. Nevertheless, while tensions remain concerning the waters of the Tigris and Euphrates rivers, it does not appear that hostilities will break out in the immediate future. Syria and Iraq have recently invited Turkey to resume regular meetings to solve problems concerning sharing the Tigris and Euphrates Rivers.

Nevertheless, Turkey has begun to wield water as an instrument of diplomacy. In exchange for a 1987 pledge of water, Turkey extracted a promise from Syria to stop supporting Kurdish rebels within Turkey. Turkey's control over the Tigris and Euphrates undoubtedly played a central role in the capture and conviction of the Kurdish leader Abdullah Ocalan. This *quid pro quo* led to a recent overture by Turkey to not use water for diplomatic leverage, with the Turkish administration very recently stating that the country will never use water as a weapon and alluding to three-way talks on water management between Turkey, Syria, and Iraq.

As freshwater demands increase in these river basins, the political necessities to jointly manage the resource will dictate that shared infrastructure be financed and constructed. To accomplish that task, investment risk must be reduced through accords that comprehensively allocate and manage the resource. The author is hopeful that with this understanding, infrastructure can be planned and developed based on an informed understanding of best management practices. This appears possible in many regions such as the Middle East since many top officials there are intimately familiar with water.[8]

The importance of stabilizing water resource conflicts is not confined to the Middle East. In Africa, eight countries share the scarce supply of the Nile in the sub-Sahara and in South Africa, and some believe that the world has already witnessed

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[7] Turkish President Suleyman Demirel is a water engineer by profession and a former director of the State Waterworks Administration. Yitzak Rabin also was a water engineer. In stressing the importance of water allocation works, Rabin once said, "If we solve every other problem in the Middle East but do not satisfactorily resolve the water problem, our region will explode." Kinzer, "Water Pressure, Turkey's Policies Spring from Water", *Minneapolis-St. Paul Star-Tribune*, March 3, 1999, at p.11A.

[8] The 1987 Protocol between Syria and Turkey guarantees Syria a minimum flow of 500 cubic meter per second in the Euphrates and the Iraqi-Syrian pact splits that amount on the basis of 58 per cent to Iraq and 42 per cent to Syria.

the first war over water in Lesotho.[9] In North America, conflict over water, primarily in the western United States and in Mexico, has led to decades of conflict followed by a treaty between the United States and Mexico and a treaty (called a Compact) between the Western States.[10]

The contentious nature of disputes over the taking of water from a shared river basin must be the first step in cooperative river basin infrastructure planning and financing. To accomplish this task, six sequential steps must be accomplished:

(1) Prior acceptance of binding determinations by a respected, empowered, and independent power;

(2) Acceptance by all jurisdictions of the prioritization of water use by location or historical use;

(3) Acceptance by all jurisdictions of the standards and principles of equitable apportionment and equitable utilization of the resource, before the investigation of demand and supply are analyzed;

(4) Acceptance by all jurisdictions of standards for measuring efficient water use and beneficial use;[11]

(5) An independent assessment of demand employing accepted standards of population and economic growth, applied to the standards of efficiency and beneficial use; and

(6) Application of the standards and principles of equitable apportionment and equitable utilization to the findings of efficient and beneficial use and population and economic growth.

The uncertainties of scarce supplies, politics, climactic considerations, and localized factors would seem to restrict the financial markets from developing stable financial models to assist in meeting the infrastructure needs of many areas of the world. However, a few similarities and standardized factors can be developed to assist in the process, particularly in the context of potable water and sewer infrastructure development and planning.

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[9] The Lesotho Highlands Water Project is a complex and aggressive project to divert, store, and transport Lesotho headwaters to meet the growing demands of South Africa. The recent incursion of South Africa troops to protect the *Katse Dam*, one of five dams in the project, resulted in 15–20 reported Lesotho military deaths.

[10] Conflicts between the United States and Mexico over the Colorado River center on quality rather than quantity. The issue surrounds the saline nature of United States deliveries to Mexico from the Colorado River and the pollution of the New River which flows to California from Mexico.

[11] This avoids cultural and ambiguous standards of water use as a "public good".

## 2. Common Characteristics of Potable Water Utility Enterprises

The provision of water services to the public, by a sovereign entity, municipal entity, special district, or other public authority (and, in more recent times private companies who service a geographic region rather than a particular project), constitutes a utility enterprise. Historically, water has been viewed as an elevated public resource, but now one must view it as a field of enterprise, regardless of whether the enterprise is owned and operated by a governmental entity. In this way, recognized and accepted economic principles can be applied so that the business community can participate and finance the water utility.

While most water utilities are subject to local regulation, the regulation must be mindful of accepted industry and financial standards and practices to attract capital. Whether the water utility enterprises are in Europe, the Pacific Rim countries, the United States, or wherever in the developed world, they share many common aspects, problems, and attributes. The provision of treated (or potable) water service requires either the receipt of water from another provider or diversion of water from a source and then treatment of the water to meet applicable standards and transmission of potable water to customers.

These three areas are common to all water providers, wherever located, and can be standardized. The areas are collection, treatment, and disposal.

## 3. Collection, Treatment, and Disposal

The same analysis occurs in the context of a wastewater (sewer) utility. The only two differences are:

(1) A wastewater enterprise deals with issues and standards over the disposal of treated effluent; and

(2) A wastewater enterprise collects raw effluent for treatment and disposal, rather than the transmission of treated water.

While, in most instances, these enterprises are self-effectuating, they also may give rise to multi-jurisdictional conflicts, treaties between nations, and environmental disputes. They are also utilities, in many jurisdictions, that are capable of returning considerable profit to the public or private utility. Yet, as with any resource or infrastructure development, proper planning will dictate whether the endeavor is costly or profitable.

## C. INFRASTRUCTURE PLANNING AND FINANCING

### 1. Master Planning, Utilities Supplies, and Physical Facilities

In representing or managing a utility enterprise, there are areas in which master planning (long-term and area-wide planning) are critical:

#### a. *Supply Side (Long-Term Volumetric Requirements)*

Long-term water supply planning is dependent on the individual basin and is site specific to area demographics and growth trends. However, there are a myriad of general planning concepts that guide the process. These include, life-cycle durations of infrastructure, water quality, pollution standards, and standardization of demands.

The concept of developing a standardized method of computing demand assures that resources will be available even if specific planning projections change. A simple and effective standardization concept is known as "Equivalent Residential Unit" or EQR. Water demand planning often assumes certain per capita demands of residential uses depending on water use characteristics of a geographic area, e.g., 100 gallons per day per capita with an assumed population of 3.5 persons per household is a common planning unit in North America. All other types of demands, i.e., commercial or industrial, can be standardized as a fraction or multiple of an EQR for planning purposes.

The benefit of this standardized unit of measurement is that water supply planning can be based on a stated EQR value which can then be used in master planning land uses so that utilities will be available and considered in the land use planning process, but does not interfere with or dictate land use planning. Utility planning must follow land use planning, not dictate it, since history has proven that attempts to affect growth or land use patterns through utilities are not successful and often yield an undesired land use result.

The same approach is applied for wastewater service master planning with two nuances: First, a wastewater EQR demand is influenced by the consumption rate of the delivered water. Second, the organic loading of the effluent is assigned a weighted factor, since not all effluent is alike.[12]

### 2. Laws and Regulations that Determine Water Quality Standards

Master planning and development of infrastructure, together with the selection of the means of financing such, are heavily influenced by applicable governmental standards, e.g., required drinking water quality standards that are imposed by a

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[12] For example, residential effluent contains no toxins and metals and is not high in organics, while restaurants are high in organics and some industrial uses are so high in other pollutant parameters as to require additional levels of treatment (or pre-treatment), These costs and processes must be planned for and assessed to the generator of the effluent.

jurisdiction.[13] Familiarity with treatment standards, whether they be drinking or potable water standards for water providers or discharge standards for treatment of effluent, enables the assessment of the anticipated duration of treatment technology which is then factored into the nature of the infrastructure to be developed.

The expected life of an improvement as well as its life cycle operation, maintenance, and repair expenses directly influence not only master planning of the infrastructure components but how they are funded and the selection of technology.

In order for a water or wastewater utility enterprise to properly plan for growth, replace aged infrastructure, and fund improvements, several legislative tools can be employed. Specifically, providers may adopt rules, regulations, and laws which have proven to be effective.

*a. Resource Dedication Requirements*

Most utility providers assess new or expanded connections a connection fee, sometimes referred to as a "tap fee," plant investment fee or "PIF", or utility connection charge or "UCC". The rationale here is to charge for that party's prorated enjoyment and use of in-place infrastructure and management. However, this fee often does not include the costs of the provider obtaining the raw water resource to divert into the in-place infrastructure. It is here that water dedication legislation can be effective.

Resource dedication programs are an opportunity for the party seeking service to either (at the election and discretion of the utility) dedicate water resources or new facilities to divert water or pay a cash fee in lieu of water being dedicated, which fee bears a relationship to the costs incurred by the utility provider in obtaining the resource for the level of demand being requested.

*b. Service or Connection Policies and Regulations Designed to Make New Connections "Pay Their Own Way"*

All internal infrastructure of a development, as a general rule, should be required, in addition to any connection charges, to be paid as a cost of the project. Similarly, off-site improvements reasonably necessary to accommodate or serve the new growth or project should also be a project cost of the party wishing to connect to the utility enterprise. The western jurisprudence phrase is a useful term here. But for

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[13] Clean Water Act, 33 United States Code, sections 1251–1387 (1994); European Community Council Directive 75/440/EEC, 1975 O.J. (L 194/26) (concerning the quality required of surface water intended for the abstraction of drinking water in the Member States); European Community Council Directive 79/869/EEC, 1979 O.J. (L271/44) (concerning the methods of measurement and frequencies of sampling and analysis of surface water intended for the abstraction of drinking water in the Member States), European Community Council Directive 91/271/EEC, 1991 O.J. (L135/40) (concerning urban waste-water treatment), and European Community Council Directive 98/93/ECC, 1998 O.J. (L 330/32) (concerning the quality of water intended for human consumption).

the new development, would the infrastructure have been built? If the answer is "no", it should be a project cost, not a cost to the utility enterprise.

#### c. *Infrastructure Repayment Legislation*

The costs of most infrastructure improvements are guided by the principles that economies of scale often encourage building capacities for which demands do not presently exist. In the case of sewer collection facilities and water transmission facilities, the costs of construction are predominantly labor rather than materials.

Utility infrastructure is often required to be over-sized, beyond the capacity necessary to serve a new project or connection, by the proponent wishing to connect to the utility. However, it the test answer is "no", then the utility should still require the over-sizing to be performed by the project proponent, but afford the project proponent the opportunity to recover the incremental (not proportional) costs of over-sizing from future connecting parties.

#### d. *Infrastructure Reserve Fees*

Increasingly, we are seeing a reserve be assessed as a separate fee for the purpose of funding future upgrades to facilities to meet increased treatment standards and, to a lesser extent, infrastructure replacement. In this way, there is a recognition that existing users, having paid a tap fee for their pro rata share of existing infrastructure, should pay a fair portion of new infrastructure required for compliance with new treatment requirements.

In addition to legislative funding tools, imposed as consideration or as an exaction for service, other funding means typically involving grant or debt financing are employed.

## D. FINANCING: TYPES OF INSTRUMENTS OF DEBT FOR UTILITIES

### 1. Debt Instruments

#### a. *Revenue-Based Financing (Revenue Bonding)*

In revenue-based financing or debt instruments, the debt is guaranteed and secured through the utility enterprise's revenue base, which usually consists of periodic service charges and connection (tap) fees.

#### b. *Loan-Based Financing*

Loan-based funding may be secured solely through revenue streams, such as service charges and connection fees. In many jurisdiction lenders perceive a risk of nationalism of infrastructure, legislative interference with collateral or other risks. Increasingly, lenders are requiring host jurisdictions to either guarantee loans

or otherwise agree in advance to the loan repayment by the utility enterprise. In most developed western countries, these risk factors do not unduly restrict the flow of capital to water and wastewater utilities.

However, in developing nations, these risks, coupled with inadequate infrastructure and low tariffs, require credit enhancements to attract capital.[14] The World Bank employs partial risk guarantees (covering specific risks such as government interference with non-performance of contractual obligations) and partial credit guarantees (covering risks of debt service obligations). Guarantees are often a prerequisite to international project finance or privatization. In addition, the Multilateral Investment Guarantee Agency (MIGA) helps encourage foreign investment in developing countries by providing foreign investment guarantees against commercial risks.[15]

*c. Taxation-Based Financing (General Obligation Bonding)*

Debt is guaranteed and secured by all means of the utility including the ability to tax property (*ad valorem* taxation). This is primarily a western concept but is beginning to gain acceptance in other regions.

*d. Grant / Loan Funding under Legislation Encouraging Resource Standards*

In many countries, the United States included, environmental and consumer protection legislation mandates minimum standards for purity of drinking water and wastewater discharges to watercourses. Revolving fund grant programs, out-right grants, interest free or reduced rate financing, and compliance defrayment incentives are often components of the legislation which assists in infrastructure financing.

*e. Assistance*

In the poorest of developing nations, assistance is available through the International Development Association (IDA), which extends interest-free loans and technical assistance. Funding is made available through contributions to the IDA from wealthier World Bank Group countries. Similarly, the middle income countries and some of the more credit worthy poorer countries designated by the World

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[14] Drastic changes that are often needed in reforming utility management, tariff structures, and installing infrastructure or replacing dilapidated infrastructure often dictate that credit enhancements be in place or participation be sequenced to attract capital and foreign investment. In recent years, the concept of Demand Responsive Approach based infrastructure improvements have been tested in developing countries. This approach centers around the principle that community involvement, awareness, and endorsement from a grass roots level must exist before the drastic changes needed to develop viable utility improvements and practices can succeed, taking into account the social and economic good of water and wastewater.

[15] Additionally, the International Finance Corporation (IFC) partners with private investment to provide loan and equity finance for business ventures in developing countries.

Bank Group qualify for infrastructure financial assistance in the form of funds backed by bonds issued in the financial markets by the International Bank for Reconstruction and Development.

#### *f. Combing Multiple Utility Issues*

Debt markets broaden and utility interest rates become more favorable when risk and "soft costs" are reduced by combining many debt issues for a myriad of utility offerings. The concept of these "special sector mutual bond funds" has grown in recent years.

Opportunities exist to create private financial concerns that finance bundled water and wastewater utilities. In developed countries or countries with high credit worthiness, the risks are relatively low to an investor if the full faith and credit of the community and the revenue streams of service charges and tap fees are security, because water and wastewater utilities, by virtue of their infrastructure, are monopolies within geographic areas. These private financial concerns have recognized that these monopolistic industries generate stable and significant revenue.

## E. INDIRECT INCENTIVES FOR UTILITIES

Increasingly, public and private utility enterprises are finding that exceeding minimum requirements for pollution control may, in certain jurisdictions, reduce development review times, delays by environmental opposition, and provide a competitive advantage in the marketplace. Examples include:

(1) Communities that attract new industries by marketing a quality of life and accompanying natural environment; and

(2) Industries or developments that provide the servicing utility funds or opportunities that enhance the utilities' environmental position.

## F. PRIVATIZATION

The 1990's saw a trend towards privatization of water and wastewater utilities. The reasons that privatization appeals to the private sector are numerous:

(1) Attributes of a recognized and allowable monopoly;

(2) Stable and secure revenue stream associated with periodic service charges;

(3) Growth potential in selected geographic areas; and

(4) The fact that the industry is not subject to trends or alternatives to the service.

Despite these attributes, privatization is not without substantial risks to be evaluated, mitigated, or assumed. The risks facing the private enterprise include:

(1) Forecasting demand and required infrastructure (which can largely be eliminated by proper master planning);

(2) Changing environmental standards;

(3) Upstream activities which impact diversions or treatment costs for water utilities;

(4) Downstream activities that influence greater treatment standards for wastewater utilities;

(5) Resource planning which includes drought planning and flood mitigation planning; and

(6) Reliable information as to the location, capacity, and condition of existing infrastructure.[16]

## G. CONCLUSION

Water and wastewater utility infrastructure demands over the next two decades are valued at trillions of US dollars. In addition, the primary component of the infrastructure, water, is a resource for which fierce competition for limited supplies will increase as the worldwide population increases. The conflicts, and perhaps the wars, of the 21st century will not be limited to territorial or religious roots, but will evolve from natural resources such as water. However, through committed and well-orchestrated mediation involving the recognized standards of equitable utilization and equitable apportionment, basin-wide resolution of allocation conflicts can be achieved allowing basin-wide management of scarce resources.

With proper planning and a universal and standardized approach to water and wastewater utility enterprises, infrastructure planning and financing can be encouraged. Ownership and representation of water and wastewater utilities are a stable and sound investment affording stable revenue streams and low risk if certain activities and precautions are employed, most notably, proper master planning and growth assimilation tools for the utility.

Traditional financing structures which have been employed in the west include public debt (bond issues), equity issues, and loans from financing institutions. However, outside of the west, financial markets have been reluctant to provide and accept financing, primarily as a result of a lack of familiarity and understanding of

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[16] This risk is perhaps the most difficult risk to assess and mitigate since a great deal of infrastructure for water and wastewater utilities was buried or was built before the advent of modern robotic and computer technology.

water and sewer activities as a traditional utility. However, extensive international loan programs, credit enhancements, and risk mitigation programs to be employed in the developing countries are available to facilitate infrastructure and operational reforms.

Just as technology, the internet, and media have shrunk our world and increased global awareness, western principles to plan and finance infrastructure replacement and expansion will be adopted to facilitate infrastructure planning and financing. It is for the west to be mindful of the pace at which these principles are transferred to the rest of the world and for the world to recognize the economic, rather than social, value of water.[17]

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17 Briscoe, *Water as an Economic Good: The Idea and What it Means in Practice*, World Bank, www-esd.worldbank./org/rdv/training/icid16.htm.

# CHAPTER 19
# CULTURAL ISSUES IN INTERNATIONAL ARBITRATION

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## A. INTRODUCTION

Not all legal cases, even international legal cases, raise cultural issues. A maritime dispute between parties from different parts of the world, submitted to a specialized maritime arbitral tribunal, normally involves straightforward differences in how the parties view the facts or the governing law, with little or no reference to local cultural differences.

Some areas of commerce have, in effect, become "international" in their scope, and local cultural elements do not usually arise when disputes arise between contracting parties with similar expectations about the conduct of the underlying business and the way disputes in that business area will be resolved.

On the other hand, many international commercial disputes do raise substantial and often difficult cultural issues affecting one or both parties. That is, issues which are not tied to the facts of the case or to differing perceptions of the governing law, but rather are based in the local culture of one of the parties, their counsel, or even of one or more members of the Arbitral Tribunal.

In these cases, the culture "tail" can wag the legal "dog", and seriously impact the proceeding or its result, perhaps without everyone involved being aware of what is happening. Participants in an arbitration proceeding seldom openly or knowingly make "cultural" arguments in support of their position.

## B. CASE EXAMPLES

### 1. Case 1 (Contract Formalities–Poland)

In 1982, an English company which leases containers to shipping lines, entered into a contract to purchase some 2,000 standard 20-foot shipping containers from a state-owned Polish manufacturer. The contract, under English law, included an option for the English company to buy an additional 2,000 containers at the same price within six months following the initial delivery. The initial containers were

successfully delivered and paid for. As there was then a shortage of containers, the market price had risen sharply and, quite understandably, the buyer gave notice under the contract to purchase the optional quantity. The manufacturer refused to deliver the additional containers.

The buyer was forced to bring a claim in arbitration in Geneva in accordance with the dispute resolution clause of the contract. The English claimant appointed an English lawyer as arbitrator. The Polish manufacturer, understandably, appointed a Polish law professor as arbitrator. The two arbitrators agreed on a respected French law professor as President of the Arbitral Tribunal.

In the arbitration, the defendant manufacturer claimed it was excused from its obligation to deliver the optional quantity as it had been unable to obtain an authorization. Despite its best efforts to obtain an authorization, no Polish government export authorization had been granted for this option transaction. Without formal state approval, the defendant said it could not legally deliver goods under Polish law.

The buyer replied that neither the terms of the contract, nor English law which governed the contract, made the sale of the optional quantity conditional on such a license. If a license was needed, it was the seller's job to obtain it. The manufacturer (rather, its Polish lawyer who came to Geneva for the arbitration) was unmoved by this argument, accepting the contract was silent on the point, but adding "no contract to be performed in Poland can be enforced without the necessary governmental authorizations".[1]

At the arbitration hearing, during and after the evidence was presented, it became clear that counsel for the Polish manufacturer was completely convinced that his formal defense was solid and that there was no way the Tribunal could rule against his client. He relied on no other arguments at all. From his perspective, in the then existing socialist legal system, it was self-evident that no transaction could be completed if the government had not given its formal "ok", which meant placing a particular stamp on the originals of the contract. He accepted that such a stamp had been placed on the contract for the initial quantity, but had not been added or extended for the optional quantity under dispute. He provided testimony of a government official who confirmed that was the procedure in Poland.

## 2. Case 2 (Employment Termination–France)

In 1990, a French software inventor sold his software patents and his French software company to an American group, agreeing to stay on as President (PDG) of the French operation for at least five years under an employment contract with the French subsidiary. Part of the overall arrangement was a separate consulting agreement between the PDG and the American corporate parent providing for a reasonable

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[1] No argument was raised (as might have been) that Polish public policy precluded performance and hence any claim on failure of performance.

generous indemnity payment if the PDG were to be dismissed ahead of time as head of the French subsidiary. In the later arbitration proceeding in Geneva, it was accepted that the purpose of this clause was to provide financial protection, i.e., a "golden parachute", to the PDG if the new owners of his business wanted him to leave before the end of the agreed five-year period.

Unhappily for the PDG, the consulting agreement was governed by New York law, and the text included a short "window" of time in which the termination could be made by the new owners without such an indemnity payment. As problems had developed rather quickly between the inventor and the new owners, a termination notice was given within this short "window", and the owners refused to pay the rather large indemnity which would otherwise have been due.

When he was dismissed, the PDG sought advice from his French legal counsel who suggested that he bring, in addition to his claim in the French court for wrongful dismissal, also a claim in arbitration against the American parent. The dispute resolution provision of the separate consulting agreement provided for arbitration in Geneva (a neutral forum), although New York law was to be applied.

In the arbitration, the PDG sought damages equal to the full indemnity amount, appointing as one might expect a French trial lawyer as his arbitrator. The American parent selected an American lawyer as arbitrator. The two arbitrators agreed on a respected Swiss lawyer and international arbitration expert as the Chairman of the Tribunal.

The PDG claimed in his Request for Arbitration that the terms of the consulting agreement had to be read in light of its "agreed" and obvious intended purpose to provide a "golden parachute" in case of the PDG's early termination by the shareholder. The American company's position was that the consulting contract provided expressly and clearly for a "window" of time in which no such termination indemnity payment had to be made and that such a clause was not ambiguous in any way and was fully valid under the governing New York law. Hence, the clause providing for the window could not be ignored or rejected or made subject to a contrary "interpretation" by the arbitral tribunal based on evidence of the parties' intention.[2]

At the deliberation stage of the Tribunal's work in preparing and issuing the arbitration award, the cultural strength of the claimant's argument became one of the major issues to be decided. The cultural argument was that, it was not morally, financially, or legally correct to dismiss a senior corporate executive, who had devoted most of his working life to the company's benefit, without some indemnity payment, particularly when that has been agreed between the parties in advance as matter of principle.

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[2] Such an interpretation of the terms of a contact under the New York parole evidence rule can be made only if the terms of the contract are ambiguous or can be interpreted in more than one way — here the term in question was a period between two fixed dates, September 1, to December 31, 1990, which could not in any way be said to be ambiguous.

Admitting that New York law would not permit any "interpretation" away from the clear meaning of the fixed dates establishing the "window," the French arbitrator argued that it was simply wrong to deny the PDG any indemnity payment at all and "some way must be found" to do justice and force the company to make a reasonable payment. His position on this was not moved by the legal arguments arising from analysis under the governing New York law. He was unwilling to issue an award he considered "simply wrong".

## C. CULTURE AS AN ELEMENT IN INTERNATIONAL DISPUTES

### 1. In General

These two examples provide an opportunity to see how culture, and more particularly what one could refer to as "legal culture", can become an important part of an international dispute in private law.[3]

The concept of "public policy" is discussed below. "Public policy" is an important factor in most national laws on international arbitration,[4] and one of the limited bases for not enforcing a foreign arbitration award under the 1958 New York Convention[5] can impact a case or a later enforcement proceeding. No such arguments were raised in either of these cases.

### 2. In the Container Case

The Polish lawyer, trained and practiced in the socialist law era of post-war Poland, was accustomed to the well-established and accepted Polish practice for export of state-manufactured goods. He accepted it as natural and correct in his society. Under the local rule, the required governmental export approval had to be evidenced by formal stamps on the right documents. Without such a stamp, there could be no question of being obligated to fulfill the terms of an export contract.

The formalistic nature of Polish socialist law at the time gave to such formalities an overriding importance in analyzing the rights of the parties to an export contract.

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[3] We are not considering the potential role of culture or legal culture in the resolution of public law disputes, but there can be no question that it is potentially as or even more important in that arena.

[4] See Private International Law Act 1989 (Switzerland), article 190, which provides that incompatibility with Swiss public policy (*ordre publique*) is one of the very limited grounds on which an international arbitration award issued in Switzerland can be challenged before the Federal Tribunal. Compare Lalive, Poudret, Reymond, *Le Droit de l'Arbitrage* (1989), at p. 427, section 190.5(e).

[5] Convention for Enforcement of Foreign Arbitration Awards, article V.2 (b), provides "2. Recognition and enforcement of an award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that: (b) the recognition or enforcement of the award would be contrary to the public policy of that country".

The Polish counsel did not appear at the hearing to understand to appreciate the Common Law contract rules under which such formal requirements simply do not exist if not incorporated into the contract.[6] Such a manner of thinking, i.e., a "legal culture", formed an essential part of the expectations of both the Polish defendant at the time of entering into the contract (for both the base and the optional quantity) and later of its local counsel when considering his client's legal position and advising, as he must have done, that the manufacturer should defend the claim in an international arbitration proceeding.

This subject had not, however, been raised at the time of the contract, and such an expectation had not been shared in any way by the buyer. Nor can the English buyer be faulted for rejecting such an argument as a "legal" excuse for taking away the clear commercial advantage which the optional quantity provided to the buyer in light of the financial circumstances currently in existence. The optional quantity was, incidentally, at that time worth some US $400,000 in financial gain to the English claimant.

### 3. In the Software Case

The claimant and his French lawyer (as well as the French arbitrator) each approached the arbitration proceeding with a serious cultural bias, which departed from the terms of the written contract.

In each of their views, it could not be imagined that the mutual intention, that the PDG would be reasonably compensated if he were to be asked to leave early, as well as the general social policy in France which supports or requires the granting of reasonable termination indemnities, would not have precedence over technical terms in an agreement to the opposite effect.

This specific issue, on which the entire result in the case turned, was not raised at the time of negotiating and signing the consulting agreement. Additionally, the PDG had sought advice of counsel on its proposed terms.

The evidence showed that, in purchasing the PDG's business, the American parent company had considered this issue and had drafted the consulting agreement intentionally to include the famous "window" provision as well as the choice of New York law to make it effective.[7] The clause in question, which was absolutely unambiguous on its face, was accepted and signed by the PDG at the time without comment or any objection.

In each of these two example cases, one party's natural "expectation" about the effect and consequences of the signed contract, and that of his counsel, were each colored by the legal culture in the home country.

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[6] Excluding the limited areas in which a writing is required under the Statute of Frauds.

[7] New York law permits the termination of an employee, or the termination of a consulting agreement according to its terms, which can mean with no termination payment whatsoever, if that is agreed.

In each case, the party having such expectation did not consider, either at the crucial time when the contract was signed or at the time the arbitration was started, the impact of the written contract terms which were inconsistent with what appeared to each party to be "natural" or correct.[8]

In international disputes, i.e., disputes involving parties from different countries or different parts of the world, the chances of the parties undertaking a commercial relationship, entering into contracts and finally proceeding with an arbitration proceeding, while under differing fundamental expectations of what is "right" as a substantive matter or what is the correct procedure to resolve a dispute, greatly increases.

In case the dispute is to be submitted, not to an arbitration tribunal, but to a local court in one or the other of the countries involved, it is not difficult to anticipate that the foreign party may experience what is often called a "foreign bias" in the conduct of the case. The foreign party will be faced with a proceeding under a different language, and virtually always with unfamiliar procedures and unaccustomed principles for judicial decision-making.[9]

Whether or not there is in fact "prejudice" against the foreign party, such a case can be expected to lead, quite understandably, to a concern with "home-town justice" against the foreign party.[10]

Parties traveling from one country to another to do business must become adept at "when in Rome, do as the Romans do" or at a minimum, adjusting their commercial and legal expectations to take into account different legal principles and policies of local entities. Failing to do so can result in their expectations being seriously disappointed.[11]

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[8] Cultural differences can also arise even in a domestic case, particularly in societies which have large minority or foreign-origin populations. In commercial cases, however, the chances of a significant cultural issue arising is greater in an international case than a purely local case.

[9] Park, "When and Why Arbitration Matters", *The Commercial Way to Justice* (GM Beresford Hartwell, Ed. 1997). See also Von Alain Plantey, "L'arbitrage international dans les nouveaux enjeux culturels mondiaux", *Festschrift für Ottoarndt Glossner* (1994), at p. 241.

[10] A recent study of United States Federal Court litigation determined that a slight majority of cases in a given period and among certain United States courts were in fact won by the foreign party, but this is not evidence that the foreign bias does not exist, as it may be simply that foreign parties avoid bringing their claims or claims against them to court unless they have more confidence in the strength of their case.

[11] The problem is not new, and was addressed already in the Middle Ages, when in developing commerce between the Italian city states, *a lex mercatoria* was already well developed for use in cases involving parties from different places. It was recognized that commerce would not flourish as well if each party insisted to apply its own local laws or the procedures of its local courts to resolve any disputes that arose in the international commerce.

The problem for parties and counsel alike is to identify the culturally based differences which may prove to be relevant in a dispute, hopefully at the time an international contract is being considered and entered into, but at any case by the time a dispute under such a contract is being resolved. This, like any diagnosis, is often easier said than done.

## D. ARBITRATION AS A "CULTURALLY NEUTRAL" WAY TO RESOLVE DISPUTES

A recent theme in international arbitration literature has been whether international arbitration institutions, whose rules take into account the multi-culture nature of the process, can be truly "culturally neutral"?

It is fashionable today to speak of a new "international arbitration culture", as described by the Secretary General to the International Chamber of Commerce (ICC) Court of International Arbitration.[12] According to this view, contracting parties from all legal systems can feel confident to obtain a "culturally neutral" forum for resolving international business disputes by selecting ICC arbitration. Indeed, the Secretary General argues that the ICC system constitutes:

> . . . the expression of a broad and carefully crafted multi cultural consensus . . . [for] the operation of international arbitration and the values involved in such operation.

This ambitious assertion is based on the premise that the ICC's International Arbitration Rules, particularly the 1998 revision, and the ICC's internal practice and procedures have been carefully crafted to insure to the maximum extent possible that the Arbitral Tribunal and the entire administration of the process will not reflect any cultural biases which could favor one party or the other.

Without denying the importance of such a goal, what can be seen in the two example cases above is that it is often the parties, rather than an arbitration institution, who fall victim of significant cultural issues which a contract and its eventual enforcement may raise.

A truly "culturally neutral" dispute resolution system will not result simply from having neutral procedural rules, such as those sought by the ICC.

If such a system can exist at all (as it in part may as in the maritime field, noted above), it requires a shared understanding by all participants in the arbitration proceeding of substantive as well as procedural practices and goals. This would be the case if there were a true *lex mercatoria* or other standardized legal principles applied

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[12] Grigera Naón, "Cultural Differences from the Perspective of the ICC Arbitration System" (New York IFCAI Conference, 1999).

in a consistent fashion. It seems pretty clear that notwithstanding the dawning of the third millennium, we are at present and into the foreseeable future pretty far away from that.

Hence, it behooves international businesses and their legal advisors to take care not to ignore cultural differences which have or may arise in transactions or disputes. Failing to do so, as in the cases noted above, can lead to serious losses, as happened to both the Polish manufacturer and the PDG, who not only lost their case, but also were condemned to pay in addition substantial arbitration costs and counsel fees for the opposing party.

## E. CULTURAL DIFFERENCES VERSUS PUBLIC POLICY

Cases in which serious cultural values or policies turns out to be involved in an international dispute can also involve arguments of so-called local or international public policy.[13]

The effect of introducing "public policy" arguments, if they exist, in resolving disputes, both local and international, can be significant. In a local dispute, under virtually all legal systems, there are certain actions which are held not only to be contrary to law, but rise also to the level of "public policy". When a court or arbitral tribunal finds that to rule in a certain way would violate local public policy, it is clear that solution is not possible and, if it is chosen by the tribunal, the judgment or award will be subject to annulment on appeal.

As noted above, for international arbitrations with a seat in Switzerland, any award which is found to violate Swiss public policy is subject to challenge before the Swiss Supreme Court (the Federal Tribunal) under DPIL, article 190 (2)(e). As can be seen, this is one of five exclusive grounds on which an international arbitration award can be challenged.[14]

An interesting argument raised is that a certain result in a litigated international dispute would violate the public policy, not of the state in which the proceeding is being conducted, but in another state, in particular that of one of the parties. The Swiss Private International Law Act provides that an international arbitral tribunal sitting in Switzerland has the discretion to consider public policy arguments

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[13] In Anglo-Saxon law, "public policy" is usually defined along the lines of being "injurious to the public or against the public good". It amounts to restrictions on freedom of contract or private dealings by law for the good of the community. Compare *Black's Law Dictionary* (1979, 6th edition).

[14] In translation, article 190 states in relevant part: "2. Proceedings for setting aside the award may only be initiated: a. where the sole arbitrator has been improperly appointed or where the arbitral tribunal has been improperly constituted; b. where the arbitral tribunal has wrongly accepted or denied jurisdiction; c. where the arbitral tribunal has ruled beyond the claims submitted to it, or failed to decide one of the claims; d. where the principle of equal treatment of the parties or their right to be heard in an adversary procedure has not been observed; e. where the award is incompatible with public policy".

raised under another legal system, and may take such public policy into account in issuing its award, but is not obligated to do so.[15]

The 1958 New York Convention for Enforcement of Arbitration Awards, which is the backbone of the international arbitration practice as it permits enforcement in all member states of an arbitration award which is valid and enforceable in the state in which it was issued, also expressly recognizes a violation of local public policy in the state of intended enforcement as a ground for denying enforcement of the award. Thus, a defendant who either unsuccessfully raises a public policy defense in an international arbitration, or even one who fails to do so, can still "try again" before its home town courts at the time an arbitral award against it is being enforced in such courts.

Thus, where a culturally based issue arises in an international arbitration, counsel should consider if it is possible to argue that such an issue rises to the level of a public policy issue, either in the seat of the arbitration or in the state in which any award adverse to his or her client may be enforced. When the issue can be seen as a public policy issue, then the chances of blocking an award against the client become much greater, and the "cultural aspect" of the case can indeed become determining.

It is equally important for the claimant's counsel to consider its own case and the claims of his or her client in a similar light. In this regard, "public policy" is not treated the same under all legal systems, and one can be surprised by what a court, particularly a court in a less developed country, may decide that it rises to this high level.

## F. MAKING THE MOST OF CULTURAL DIFFERENCES

It is clear that business parties and their counsel must be sensitive to the existence and possible impact of cultural differences in the context of an international commercial dispute, and their possible exploitation as matters of public policy.

From the perspective of an international arbitral tribunal, it is not all that unusual for a party or its counsel to have trouble understanding the foreign legal principles or trial procedures which may be involved in a particular multi-jurisdictional case. This is as true in international arbitration (whether or not an "arbitration culture" is developing) as in the case where the party is forced to litigate in a foreign court and face the consequences of a truly foreign law, procedure, language, as well as cultural setting.

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[15] Swiss LDIP, article 19, providing that, in the discretion of the tribunal, mandatory provisions of a foreign law may be taken into consideration in a Swiss court or in a Swiss arbitration proceedings if there is a sufficiently close connection of the matter with that country. We do not here get into the interesting area of "international public policy" and its application in international commercial arbitration proceedings. Bucher and Tschanz, *International Arbitration in Switzerland* (1989), sections 205–210.

If the lawyer fails to appreciate the cultural issues, the client may well be advised to proceed when the opposite advice should have been given.

A further, and perhaps more subtle but even more important, level of concern when cultural issues are or may be present in an international arbitration proceeding is in the choice of the arbitrator or arbitrators. In a sole arbitrator situation, it is imperative that the arbitrator be sensitive to parties with different cultural background. In a three-member tribunal (which is the standard situation for most commercial cases), the first concern is in the appointment of the party-appointed arbitrator, and then the issue is raised again, even more importantly, in the choice of a chairman for the tribunal. The selection of an appropriately cultural sensitive individual, with the appropriate expertise and persuasive powers, can make or break the case during the tribunal deliberations.

In a three-member tribunal, an arbitrator who has not recognized a culturally biased argument or position of one of the parties, and supports it, on the basis of a similar bias, will seldom at the end of the day be able to carry the other two arbitrators, especially if they are from different legal systems and cultures. That party will virtually always lose the arbitration.

If the goal of participating in an international arbitration (or litigation) is to win, and virtually all clients I have met have such an idea in their mind when a case commences, then one does not want to find oneself in such a bind.

Rather, an international business entity should take the necessary steps, with local counsel from each area of the world in which it does business, or at least under whose law it agrees to submit its future disputes, to ferret out the distinct cultural as well as legal aspects of its contract and its performance, if any exist. This will avoid parties being surprised at the time a dispute arises or, worse still, when an arbitration award is issued that fundamental assumptions which have been made and relied on in undertaking the business prove in the relevant context to be inapplicable.

International lawyers specializing in multi-state transactions and resolution of multi-state disputes can far better serve their clients in many if not most cases by keeping this principle well in mind.

## G. CONCLUSION

Counsel who understand and deal correctly with the cultural issues in an international dispute, like a criminal lawyer skilled in addressing a jury, can use such issues to an advantage. Those who would ignore cultural forces may well find the tribunal going the other way and may not understand why. Yet, the analysis of cultural issues in international arbitration has not until recently been a point of particular interest either to academics or practitioners.

International arbitrations are generally handled by specialized lawyers, trained to deal with legal issues. These practitioners may not be as adept at identifying and handling the cultural aspects of a case.

The key in some cases hides in the difficult and sometimes arcane legal arena of public policy, or more exactly of either "local public policy" or "international public policy". These terms, never well defined and often misunderstood by practitioners and courts alike, have their bases in cultural values in the country concerned.

What becomes clear when one looks at international arbitration in general is that, when cultural issues can be converted to "public policy" issues, the parties' relative positions in the arbitration proceeding or in a subsequent enforcement proceeding can be significantly affected. Winning cases can be lost without the claimant being aware of what went wrong.

# CHAPTER 20
# DISPUTE RESOLUTION IN MAJOR INFRASTRUCTURE PROJECTS

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## A. INTRODUCTION

A number of risk factors are generally present in major projects, and there is a variety of ways of providing different dispute resolution mechanisms to cope with such risk factors. The risk factors are:

(1) Long-term relationships between the parties;

(2) Particularities of the construction industry;

(3) Multinational origins of the parties;

(4) Involvement of governmental entities, especially from developing countries; and

(5) Multiplicity of parties and contractual relationships.

It is suggested that:

(1) Some method of non-binding Alternative Dispute Resolution (ADR) is always recommendable to minimize the disruptive effect of conflict in such long-term relationships;

(2) It is also recommended to provide for a Dispute Resolution Board (DRB) for the construction side of the project; and

(3) Arbitration is the most effective binding adjudication method to solve disputes between the parties, notwithstanding the problems arising from multiparty, multi-contract arbitration.

## B. MINIMIZING THE IMPACT OF CONFLICTS

Once the conflict has arisen, the lack of an efficient system to channel and solve only makes things worse by disrupting the cooperation between the parties and turning what was deemed to be a win-win situation into a lose-lose scenario.

Only in exceptional cases will the winning party in an adjudication process, where the parties' cooperation was disrupted, completely recover the time, effort, money, and opportunity costs that were spent in the process of solving a dispute inefficiently channeled and managed. The real problem is when a conflict disrupts the cooperation between the parties. Conflicts can coexist with cooperation if there are appropriate means to channel such conflicts.

Effective dispute resolution mechanisms are not a "boiler plate". They should be tailored to fit the particular context in which they are expected to operate. Not all the mechanisms that modern ADR provide for are suitable for every type of transaction and, in many cases, not all the conflicts that may arise in connection with a particular transaction should be channeled and solved in the same way. Besides, each particular dispute resolution mechanism can be adapted to fit the particular circumstances of a certain transaction.

In many cases, the existence of procedures to channel disputes smoothly diminishes *per se* the possibility of disrupting conflicts. This is because parties envisioning extremely adversarial methods, like litigation, as the sole remedy for their disputes, tend to behave more defensively and strategically, and less cooperatively and openly, for fear that anything they may say or do "can be used against them in a court of law".

The likelihood of disputes and their nature will greatly depend on the type of the interaction and the context in which such interaction takes place. It is impossible to know in advance how many conflicts or what types of conflicts shall arise throughout a particular project. However, it is possible to identify *ex-ante* the most significant risk factors present in a particular context, and to tailor particular procedures to minimize the risk of disruptive conflicts by channeling and solving disputes in an as effective and economically efficient manner as possible.

## C. RISK FACTORS IN MAJOR INFRASTRUCTURE PROJECTS

### 1. Economic Relations

Major infrastructure projects generally include several features that would rank them at the top of the list of the economic relations likely to be disrupted by conflicts.

Major infrastructure projects present most of the risk factors that are generally associated with the construction industry, as well as some others that are inherent to public utilities, to particular geopolitical environments, and to the fact that the interactions generally involve transnational flows of capitals, services, people, and goods between individuals and entities with different cultural backgrounds, languages, and expectations.

In the main, those risk factors are the following:

(1) Long-term relationships between the parties;

(2) Particularities of the construction industry;

(3) Multinational origins of the parties;

(4) Involvement of governmental entities, especially from developing countries; and

(5) Multiplicity of parties and contractual relationships.

## 2. Long-Term Relationships between the Parties

Infrastructure projects are not ephemeral transactions. Parties are bound to each other for a very extensive period of time. The construction phase generally requires several years. In addition, irrespective of what is being built (dam, bridge, or tunnel), it is deemed to be a durable good and able to perform a specific function during a very extensive period of time. The general use of Build Operate Transfer (BOT) agreements involves a day-to-day interaction between the operators and the local authorities that can often last for decades. Disbursements from the funding sources will take place throughout the development of the project or at least during its construction phase. Reimbursement of those loans, bonds, or other forms of debt, or the exercise of put or call rights that may have been established also might take place during significant periods of time.

The longer the interaction lasts, the more likely disputes may occur. The logic is very simple — the possibility of foreseeing future events is a function of time, and unpredictable changes in circumstances are one of the most important sources of conflict.

## 3. Particularities of the Construction Industry

Construction works cannot be stopped indefinitely while the parties settle related disputes. The construction industry requires particular expertise when it comes to solving disputes while maintaining the construction of the project.

Unforeseen events requiring some degree of adaptation are likely to arise in every major infrastructure project, and are a common source of conflict between the parties. In this context, parties generally need to have somebody taking complex decisions while the project continues. This raises issues concerning the qualification of the person to take such a decision, his impartiality, and the significance of his findings when it is necessary to settle definitively the dispute at a later stage.

## 4. Multinational Origins of the Parties

Often, the construction of a bridge in Texas involves American only participants. However, it is often the case that major infrastructure projects are the product of an international bidding open to companies from around the world. This is the case especially in countries which lack the necessary expertise and sophistication,where these projects generally end up in the hands of foreign companies.

Different languages, business practices, and cultural environment provide for a cocktail in which disputes are likely to arise. The term *ahora mismo o ahorita mismo* from a Mexican subcontractor has different connotations from its translation as "right now" or "immediately" from a banker in the City of London.[1]

The main problem of multinational interactions is that parties do not feel comfortable when they initiate a legal action or when they are sued in a foreign jurisdiction. They perceive foreign jurisdictions as not trustworthy or biased in favor of locals. Unfamiliarity with procedure, local culture, language, and legal environment are concomitant sources of concern.

## 5. Involvement of State-Owned or Governmental Entities

Most major infrastructure projects go beyond the merely private business realm since they are involved or connected with the operation or construction of public utilities. This gives rise to the intervention of governmental or state-owned entities not only for regulatory purposes, but also because in many cases they are either the former monopoly or the ultimate beneficiaries of the project. Whether in the role of regulators, customers, or beneficiaries, governmental entities may be volatile counterparts.

Bureaucracy can undermine the most well-planned project since the priorities, interests, and incentives that set the pace in the public sector differ greatly from those of the private sector. Besides, different political agendas resulting from changes in the composition of the government (either local or national) can affect the best-conceived project no matter how many insurance policies and other protections have been adopted.

The involvement of puplicly-owned entities or even of government may impose particular jurisdictional or enforcement constraints as a result of suvereign immunities which ought to be addressed, to the extent possible, at the earliest stages of the projects.

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[1] Nouel, "Cartesian Pragmatism: Looking for Common Principles in French and English Law", *International Business Lawyer*, January 1996; Raoul-Duval, "English and French Law: the Search for Common Principles", *International Business Lawyer*, April 1997.

It should be noted that developing countries are a common setting for major infrastructure problems. It is not clear, however, whether the attention that project finance in developing countries receives in seminars and in the literature is due to the fact that there are so many of these projects, or to the fact that the features of such a scenario represent the ultimate challenge to experts in the field.

Problems can be expected from entering into long-term relations with governmental entities which are accompanied by political and economic instability, lack of sophisticated or evolving regulations, non-independent and an inefficient judiciary, and often a weak rule of law.

However, developed countries are not completely free from these problems, and the parties should not feel that they are immune to these problems. Country risks are basically assessed on the basis of a track record, and the maintenance of such a track record cannot be taken for granted.

On the other hand, it is neither realistic nor fair to consider developing countries on an equal footing with regard to country risk. Without entering in detail, it is obvious that the risks involved in a project located in Chile differ significantly from those associated with a project in Indonesia, which also happen to be different from those risks associated with a project in Sierra Leona.

### 6. Multiplicity of Parties and Agreements

Major infrastructure projects involve the efforts of multiple parties. Concessionaires, contractors, subcontractors, public entities, financial sources, insurance companies, and fiduciaries, just to cite the most common participants, form a complex and interdependent network of vertical and horizontal relations that is usually set forth in multiple agreements.

The tendency in the world of business to specialize in a particular field and to outsource a great deal of the activities at the expense of the old-fashioned "do-everything conglomerates" has resulted in the intervention of a greater number of parties participating in each project.

In many scenarios, failure of one participant to comply with its obligations may create a chain reaction of non-compliance that disrupts the whole scheme. In such a context, the main problem is how to provide for a method to settle as efficiently as possible any disputes which arise in one of the involved relationship so as to avoid the chain reaction and to settle interrelated disputes involving multiple parties belonging to the same or to different contractual arrangements.

## D. RISK FACTORS ASSOCIATED WITH MAJOR INFRASTRUCTURE PROJECTS

### 1. Dispute Resolution Mechanism

Designing a dispute resolution mechanism is a twofold operation. First, parties should agree on the appropriate system or combination of systems. Second, they must choose the proper wording or incorporate directly or by reference to the most convenient model clauses.

There are plenty of very competent national and international institutions that have been developing, testing, and adapting standard contractual forms throughout several decades. These forms are well known and are a major assistance to parties in the process of drafting the terms of particular agreements by reducing transaction costs and providing a familiar framework to the negotiations.

### 2. Long-Term Relationships and the Importance of Alternative Dispute Resolution

The longer the duration of a relationship, the greater the risks of conflicts disrupting the cooperation between the parties. This problem is aggravated, in the context of infrastructure projects, by the complexity of the interactions between the various participants. In such a context, the availability of procedures to minimize the impact of conflicts by fostering cooperation or channeling differences in a constructive way is absolutely necessary.

The alternative dispute resolution (ADR) field has blossomed in the United States during the last 20 years. ADR and its connected disciplines have found their way to the core of international relations, family relations, neighboring relations, economic relations and, of course, infrastructure projects.[2]

Europeans have traditionally been more skeptical about ADR and, in general, consider ADR a mere repackaging and re-branding of traditional conciliation and mediation methods by the Americans.[3] The United States has advanced and developed the process of systematization and methods used. There are well-tested conflict prevention methods like partnering, which helps to foster cooperation and to smooth potential disagreements, and there are several non-binding methods, such as mediation, dispute review boards (DRB), mini-trials, and non-binding arbitration that may help in some contexts to reduce the impact of disputes.

The correct combination of methods will vary from case to case. An excessive accumulation of ADR systems in a particular context may increase costs

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[2] Myers, "Developing Methods for Resolving Disputes in World Wide Infrastructure Projects", *Journal of International Arbitration*, Volume 13, Number 4, 1996, at p. 101.

[3] Werner, "ADR: Will European Brains Be Set On Fire", *Journal of International Arbitration*, Volume 10, Number 4, December 1993, at p. 44.

excessively and may delay the necessary binding adjudication solutions. The introduction from the outset of at least one method of ADR, such as mediation, is highly recommendable. If parties are willing to cooperate, there is always room to provide for other dispute resolution systems. In the case of construction agreements, it is fundamental to provide for DRB.

### 3. Complexities of the Construction Industry and the Dispute Review Boards

In construction projects it is fundamental "to keep the job going when disputes break out that require fast decision, so as not to hold up the progress of the work".[4] Common law countries are especially inclined to initially defer the disputes arising from the works to the engineer in charge of the project.

The problem arising with the engineer is that he is not only an employee or the representative of one of the parties but also an administrator of the contract which he may have drafted, and so may find his own actions the subject of a dispute.[5] In response to the concerns created by this quasi-judicial role of the engineer, the leading international lender for major infrastructure projects, the World Bank, in 1995 modified the Standard Bidding Document-Procurement of Works and introduced the system of DRB as a mandatory requirement in contracts exceeding US $50 million that are financed by the Bank.[6]

The *Federation Internationale des Ingenieurs-Conseil* (FIDIC) introduced the DRB (actually called Dispute Adjudication Board — DAB) in its Conditions of Contract for Design/Build (the "Orange Book"), in 1996, in its Conditions of Contract for Works of Civil Engineer Construction (the "Red Book"), and more recently in its Silver Book providing for Conditions of Contract for EPC Turnkey Projects.[7]

The DRB is an independent body that is appointed at the beginning of the project and is supposed to be kept regularly informed about the progress of the works, and to visit the site regularly. Given the nature of the tasks, the members of the

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[4] Myers, "Developing Methods for Resolving Disputes in World Wide Infrastructure Projects", *Journal of International Arbitration*, Volume 13, Number 4, 1996, at p. 103.

[5] Seppala, "The New FIDIC Provision for a Dispute Adjudication Board", *The International Construction Law Review*, Volume 14, 1997, at p. 443 *et seq*; De Cazalet and Reece, "Conditions of Contract for Design-Build and Turnkey", *International Business Law Journal*, 1996/3, at p.279 *et seq*.

[6] Seppala, "The New FIDIC Provision for a Dispute Adjudication Board", *The International Construction Law Review*, Volume 14, 1997, at p. 453; Jaynes, "Dispute Review Boards: The World Bank is Aboard", *International Construction Law Review*, Volume 13, 1996, at p. 17 *et seq*.

[7] De Cazalet and Reece, "The New FIDIC EPC BOT Contract", *Project Finance International* 180, November 3, 1999; Cornes, "The Second Edition of the New Engineering Contract", *The International Construction Law Review*, Volume 13, 1996, at p. 97 *et seq;* Barnes, "The New Engineering Contract — An Update", *The International Construction Law Review*, Volume 13, 1996.

Board should generally be a mixture of construction professionals and lawyers. Direct involvement of the parties' management is also a key to the success of the DRB process.

DRB brings an important dose of neutrality, improving the likely quality of the decision without sacrificing significantly the pace of the procedures. It also provides for a reliable source of evidence in the event of arbitration or litigation since the findings, recommendations, and decisions can be later used in more thorough processes of adjudication, such as arbitration or litigation. This is extremely important since the DRB members might have access to evidence that would have otherwise disappeared as a result of the works.

Nonetheless, the merits of DRB should not be overstated. It has been noted with reason that the Board may have little time or no time for independent investigation and, given the summary nature of the proceeding, its decisions may be of relatively limited value in the context of complex disputes.[8] It has also been noted that the Board's decisions will not ordinarily constitute an arbitration award and, consequently, may not be readily enforceable internationally.

### 4. Arbitration as an Effective System

There can be no doubt that arbitration deals more effectively than ordinary litigation before the courts with the issues arising from the multinational origins of parties to infrastructure projects and the involvement of governmental entities in such projects. One of the main advantage of arbitration over litigation is that it provides the possibility of deciding who is going to settle definitively the disputes and how. The result of such autonomy is a perception of neutrality, expertise, and possibly greater predictability.

The perception of neutrality is extremely significant in the international arena since parties are naturally reluctant to become involved in legal procedures before foreign courts. Such reluctance can be the product of an unjustifiable paranoia, prejudice, fear of the unknown and unpredictable, and in some cases simply common sense. Whatever the explanation, parties believe that courts have a tendency to favor local interests. Arbitration provides the parties engaging in international economic interactions with a vehicle to overcome this reluctance.

Another significant advantage of arbitration over litigation stems from the referred perception of neutrality, and obtaining the recognition and enforcement of foreign arbitration awards is easier than obtaining the recognition and enforcement of foreign court decisions. The reason is simple: jurisdictions covered under the 1958 New York Convention outnumber those covered by treaties concerning the recognition of foreign judicial decisions, which are generally regional or bilateral.

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[8] Seppala, "The New FIDIC Provision for a Dispute Adjudication Board", *The International Construction Law Review*, Volume 14, 1997, at p. 443.

In the absence of such treaties, recognition of foreign decisions is on the basis of rules that tend to broaden the grounds to resist enforcement. This advantage would also exist for arbitration conducted under the 1965 Washington Convention (ICSID).

Arbitration was not long ago mostly circumscribed to settle disputes between private parties or between governments. That has changed significantly during the last years, and the perception of neutrality is at the core of such change. State-owned entities, traditionally used to shielding themselves behind the principle of sovereign immunity, have become more receptive to the idea that the better way to solve disputes with foreign private parties is arbitration. This change is especially noticeable in developing countries, whose receptivity to arbitration is the response to the need of attracting foreign investment.

The exteriorization of this new attitude is the phenomenal increase in the number of Bilateral Investment Treaties (BITs), which generally incorporate by reference the possibility of arbitration pursuant to the rules of the UNCITRAL or of the International Center for Settlement of Investment Disputes (ICSID) established by the Convention on the Settlement of Investment Disputes Between States and Nationals of other States, open for signature in Washington in 1965. Indicative of this tendency is the fact that, by 1 January 1999, this convention had been signed by 146 countries and ratified by 131.

Apart from neutrality, arbitration offers, in contrast to litigation, a great deal of flexibility by allowing the parties to adapt the proceedings to the circumstances of a particular project. This possibility of tailoring procedures is the source of two other significant advantages of arbitration over litigation. An advantage is that the composition of the tribunal to decide the dispute is appointed by the parties or by an institution selected for that purpose. The member or the members of the tribunal are more experienced on the subject matter than the average court. A second advantage is that the speed of the proceedings is flexible for each project.

Whether arbitration is faster and cheaper than litigation is a debatable subject. The complexity of some disputes and the difficulties to speed procedures due to the logistic and coordination problems connected with the scheduling of hearings have affected arbitration's image of celerity. The relevant question is what would have been the costs and the length of the procedures should the same case have been decided by ordinary courts.

While the most significant advantages of arbitration are connected with its contractual nature, its most significant deficits are related to the correlative effect of such nature: the lack of *imperium* of the arbitral tribunals. This might be a source of complications with regard to basically two different matters. First, is the immediate availability of provisory measures such as injunctions. However, seeking such measures before a domestic court is not incompatible with arbitration proceedings, and there might be conflicts of jurisdiction with regard to the tribunal that can grant provisory measures. Second, problems arise with the administration of multiple interrelated disputes arising from multiple contracts coordinating the interaction of multiple parties.

## 5. Problems of Multiplicity of Parties and Multiplicity of Contracts

This is probably the most complex and dangerous ingredient with regard to the dispute resolution aspects of major infrastructure projects. The same facts can trigger a chain of multiple interrelated disputes between parties that although performing obligations connected with the same economic goal, are bound by legally independent contractual relations.

It has been argued "that domestic litigation seems better adapted to certain situations than international arbitration, namely those involving related proceedings".[9] This can be explained by the fact that courts are empowered to order consolidation of different procedures independently of the wishes of the parties.

Consolidation of procedures is especially relevant in a context of disputes involving multiple parties because it permits a single tribunal to decide together inter-linked disputes to eliminate the risks of conflicting decisions based on the same facts. Consolidation of procedures "is based on the fundamental principle of good administration of justice in order to secure justice between the parties by avoiding conflicting decisions for related issues, serve procedural efficiency, and save time and costs".[10]

Given the contractual nature of arbitration, compulsory consolidation only works with regard to arbitration procedures in a very restrictive universe. However, this does not mean that in most cases the issues connected with this multiple-party, multiple-contract feature cannot be manageable. It should be stressed from the outset that plurality of parties is quite common to arbitration procedures and it does not generally create major inconveniences.[11]

## 6. Common Scenarios in Major Infrastructure Projects

There are several situations that should be clearly distinguished. Some of the more common infrastructure project disputes follow:

(1) X, Y, and Z are parties to contract C, and arbitration is provided for in clause A;

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[9] Leboulanger, "Multi-Contract Arbitration", *Journal of International Law*, Number 4, 1997.

[10] Leboulanger, "Multi-Contract Arbitration", *Journal of International Law*, Number 4, 1997, at p. 54.

[11] Between 1984 and 1988, 21 per cent of the requests of Arbitration before the ICC involved more than two parties. Bond, *The Experience of the ICC International Court of Arbitration, in Multiparty Arbitration*, ICC Publication 480/1. In 1992 the number of cases received involving more than two parties was 20.9 per cent of the total received by the ICC during the year. Schwartz, "Multi-Party Arbitration and the ICC. In the Wake of Dutco", *Journal of International Arbitration*, Volume 3, 1993, at pp. 6 *et seq*.

(2) X, Y, and Z are parties to contracts C1 and C2, and arbitration is provided for both in clause A;

(3) X, Y, and Z are parties to contracts C1 and C2, and arbitration is provided for both contracts respectively in arbitration clauses A1 and A2;

(4) X and Y are parties to contract C1, and arbitration is provided for in arbitration clause A, and Y and Z are parties to contract C2, and arbitration is provided for in arbitration clause A; and

(5) X and Y are parties to contract (or relation) C1, and arbitration is provided for in arbitration clause A1, and Y and Z are parties to contract C2, and arbitration is provided for in arbitration clause A2.

Case 1 is typical to the relations between the parties at the core of the project and it can be the result of different contractual structures. For example, it can be the product of a master contract establishing the main obligations of the parties *vis-à-vis* each other, or the product of an independent agreement that is included by reference in all or some of the agreements that the parties entered into.

Case 2 can be the result of the parties rearranging the terms of previous engagements with regard to the project, or new engagements also connected with the project.

Case 3 can result from the fact that parties have agreed that, while the disputes arising from the main construction contract shall be solved pursuant to the rules of the International Chamber of Commerce (ICC), which is the institution with greater experience in the field, the disputes arising from an ancillary contract on transfer of technology shall be decided pursuant to the rules of the World Intellectual Property Organization (WIPO), which have been especially crafted to deal with this kind of dispute.

Case 4 is typical to the relations between the parties at the core of the project and collateral parties, e.g., subcontractors.

Case 5 may reflect the possibility of ICSID arbitration, pursuant or not to a bilateral investment treaty between one of the parties to the infrastructure project and the host government coexisting with, for example, an ICC arbitration clause between the other parties to the project.

Case 1 can be described as "multiparty, single-contract arbitration". The problems that are likely to arise in that context are generally manageable and are mostly related to the composition of the tribunal. All the other cases can be described as "multiparty, multi-contract arbitration". As well as problems with regard to the composition of the tribunal and the conduct of the arbitral proceedings, these cases are likely to present problems concerning the interrelation of disputes and proceedings, such as the possibility of consolidating disputes, coordinating different arbitral procedures, and benefiting from the findings and awards *vis-à-vis* third parties.

All five situations can be presented in the context of major infrastructure projects. However, while the problems arising from Case 1 are always the consequence of poorly drafted clauses, the problems arising from the other cases can be either pathological or simply the product of a deliberate decision.

In every major infrastructure there is some atomization of contractual instruments and arbitration clauses. It is not realistic to expect a single arbitration agreement covering each and every single dispute between each and every single party. It should be borne in mind that arbitration agreements are the product of negotiation between the parties and that it might not be in the best interest of some of them to include overreaching clauses.

As a result of the foregoing, it might not always be the right question to wonder: which would have been the perfect arbitration agreement or the perfect constellation of arbitration agreements? In some cases the right question would be: what did the parties expect when they opted for a particular coordination of arbitration agreements or for a particular wording? In other words, while it is fair to assume that all parties expected to sign a valid arbitration clause, it should not be assumed that all parties negotiated the terms of the arbitration clauses with identical objectives.

In any event, whether a single arbitration agreement or a constellation of them with different degrees and types of coordination, it will greatly depend on the language that the parties have included.

## 7. When Is Consolidation Feasible?

Given the contractual nature of arbitration, "in the absence of an ad hoc clause, bringing together in a single arbitration all the various parties to a complex contractual structure will only be possible if the construction of the arbitration clauses reveals an intention to that end, express or at least implied, on behalf of the various parties".[12] Such implied intention is to be construed on the basis of:

(1) The economic interdependence of the contracts, where there are multiple contracts and there is a degree of factual and economic interrelation of the contracts;

(2) The arbitration rules adopted by the parties. There are certain arbitration rules that provide for consolidation in certain cases while others do not. For example, the rules of the International Chamber of Commerce and those of the Chamber of Commerce of Zurich provide for consolidation in certain circumstances; and[13]

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[12] Hanotiau, "Complex-Multicontract — Multiparty-Arbitrations", *Arbitration International*, Volume 14, Number 4, at p. 376.

[13] International Chamber of Commerce Rules of Arbitration, article 4(6).

(3) The applicable rules to the procedure. There are very limited jurisdictions that provide for the possibility of consolidation of arbitration procedures in certain cases. The applicability of such rules to a particular case can be either the product of an explicit decision by the parties or result from the seat of the arbitration.[14]

In general terms, while compulsory consolidation of procedures with regard to a single-contract arbitration (Case 1) and contracts with the same arbitration clause and economically interdependent (Case 2) is possible in certain conditions, compulsory consolidation of procedures involving different arbitration agreements (Cases 3 and 5) and third parties (Cases 4 and 5) is rather unlikely. Of course, such impossibility would be overcome if the parties consented to consolidation.

However, this does not mean that litigation is preferable to arbitration, or that parties to multi-contract projects are condemned to litigate several times on the same issues with different parties. The problem is when the parties do not provide solutions to this arbitration problem when drafting the arbitration agreements.

## E. KEY ELEMENTS TO CONSIDER IN DRAFTING AN ARBITRATION CLAUSE

### 1. Freedom to Determine What Disputes Should Have Arbitration

An arbitral clause should never be a "boiler plate". A poorly drafted clause may turn into a worse scenario in an arbitration context, i.e., to litigate with regard to the validity, applicability, or circumstances of the arbitration. When that is the case, international litigators, wonder if it would have been better not to have an arbitration clause at all.

Unfortunately, in many cases, highly sophisticated contracts prepared by highly sophisticated professionals do not provide for a well-drafted arbitration clause.[15] There are many relevant elements in an arbitration clause, and there is plenty of literature concerning the significance and relevance of each of the elements of an arbitration clause or agreement.[16] The single most important and fundamental rule of arbitration is that parties have, as a general rule, the freedom to determine what disputes shall be settled by arbitration, when they will happen, and how it will happen.

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[14] Legislation from Hong Kong, the Netherlands, the State of Massachusetts, or the State of California. Leboulanger, "Multi-Contract Arbitration", *Journal of International Law*, Number 4, 1997, at p. 58.

[15] Craig, Park, and Paulsson, *International Chamber of Commerce Arbitration*, 2nd Edition, at p. 158.

[16] Ball, "Just Do It — Drafting the Arbitration Clause in an International Agreement", *Journal of International Arbitration*, Volume 10, Number 4, December 1993.

Even a clause only prescribing that "the parties shall submit disputes to arbitration" may work to create arbitral jurisdiction in certain cases. The problem is that without cooperation from the defendant, the claimant may face the prospect of extremely long and expensive procedures to constitute the tribunal, to obtain an award and, finally, to enforce such award.

A reference of the type that "all disputes arising in connection with this contract shall be settled in accordance with the arbitration rules of the International Chamber of Commerce" may suffice in most ordinary cases to reach an enforceable decision within a reasonable period of time. It may even work in some contexts related to infrastructure projects. However, it may be insufficient to provide the required degree of efficiency in a complex situation. Multiparty arrangements have some peculiarities that should be carefully analyzed when negotiating the terms of the arbitration clauses.

## 2. Selecting the Rules for the Arbitration

Parties could craft every single detail of the "what, how, and when" of each arbitration agreement, but that would imply in many cases an enormous waste of resources since, as we all know, several national and international institutions have bothered to develop highly sophisticated "packaged" arbitration rules that can be included in an arbitration clause simply by referring to them.

Most of these rules provide for sound procedures to decide the substantive applicable law, the law governing the validity of the arbitration agreement, the appointment of the tribunal, the fees of the arbitrators, the language of the procedures, the seat of the arbitration, and other relevant issues.

The most well known are the rules of the International Chamber of Commerce (ICC), the rules of the American Arbitration Association (AAA), the rules of the London Court for International Arbitration (LCIA), and the rules elaborated by the United Nations Committee on International Trade Law (UNCITRAL).

While the rules of the LCIA and the AAA provide for procedures more according to the uses of Common Law countries, the ICC will provide for a more civil law oriented vision of certain issues and, in particular, those related to the production of evidence.

The most important element when incorporating by reference a particular set of rules is to make sure that we are aware of what we are agreeing to. Arbitration rules can impact several aspects of an arbitration procedure, such as appointment of the arbitrators, evidence, consolidation of procedures, and costs.

### 3. Appointing the Arbitrators

A typical problem in single multiparty arbitration clauses is the lack of coordination between the number of parties to a dispute and the procedure adopted to appoint arbitrators.

The procedure is usually that each party appoints an arbitrator, and those arbitrators then jointly appoint a chairman to the tribunal. It has the obvious advantage of providing the parties with a significant degree of confidence with regard to integration of the panel since two of the members can be deemed to have been directly or indirectly selected by them.

In poorly developed arbitration clauses, such procedure may give rise to difficulties in certain jurisdictions when there are more than two parties, multiple claimants or defendants, and all parties fail to agree on the appointment of an arbitrator. An ICC arbitration a dispute over the appointment of arbitrators resulted in *Siemens AG and BKMI Industrienlagen GmbH v. Dutco Construction Co.*[17]

In the *Dutco* case, the French *Cour de Cassation* held, with regard to the old practice of the ICC of treating multiple defendants as one party for purposes of nominating an arbitrator, that the principle of equality of the parties in the designation of arbitrators "is a matter of public policy" that "can be waived only after the dispute has arisen".

The problem to be borne in mind is that certain jurisdictions may be especially sensitive to the procedure of appointing the tribunal. The alternatives to avoid this problem are not numerous. The most obvious is to provide for an appointing institution to appoint all the members of the tribunal either with regard to any dispute or with regard to disputes involving more than two parties.[18]

### 4. Consolidation of Interrelated Disputes

Parties should not count on compulsory consolidation of procedures. For that reason, it might be advisable, if the parties to a particular contract or group of contracts presume that interrelated disputes are likely to arise, to provide for mechanisms

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[17] *Siemens AG and BKMI Industrienlagen GmbH v. Dutco Construction Co*, January 7, 1992.

[18] The new ICC rules, to avoid the "*Dutco* effect", provide as follows: "Article 10.(1) Multiple parties. Where there are multiple parties, whether as Claimant or as Respondent, and where the dispute is to be referred to three arbitrators, the multiple Claimants, jointly, and the multiple Respondents, jointly, shall nominate an arbitrator for confirmation pursuant to article 9.(2) In the absence of such a joint nomination and where all parties are unable to agree to a method for the constitution of the Arbitral tribunal the Court may appoint each member of the Arbitral Tribunal and shall designate one of them to act as chairman. In such case, the Court shall be at liberty to choose any person it regards suitable to act as arbitrator, applying article 9 when it considers this appropriate".

to avoid inconsistent decisions. Unfortunately, arbitration institutions do not provide for model clauses with regard to this matter. The most common solutions would be:

(1) A provision establishing that a single tribunal shall decide all the disputes between the parties in the context of a single arbitration procedure. This solution is extremely practical and efficient for obvious reasons. It is important to set up a mechanism to ensure that all the interrelated disputes are submitted to the same arbitration. However, parties should be aware that by adopting this provision they might be sacrificing to some extent the confidential nature of arbitration.

(2) A provision establishing that all the interrelated disputes shall be decided by identical arbitration tribunals which operate parallel procedures. A variation of this solution would be to establish that the tribunals would have a common chairman. While not as efficient as the previous solution, a provision of this kind should allow for a significant degree of coordination between the parallel procedures. In particular, the tribunal may practice a sort of *defacto* consolidation by appointing the same experts and coordinating the calendar of the procedures to avoid inconsistencies as well as pre-judgments.

(3) An express consent to the consolidation of arbitral proceedings. The problem with consolidation clauses is that they are not easy to design, and there are no institutional model clauses to profit from. Regardless, counsel should be able to draft a workable clause. In particular, attention should be paid to the definition of the circumstances triggering consolidation and to the method of appointing the tribunal.

The solutions referred above may help to minimize the risks of inconsistent decisions with regard to disputes within the context of a single arbitration agreement. The reference to a singular arbitration agreement includes master agreements, framework agreements, or any kind of umbrella agreements, as well as repetition of an identical arbitration clause in the context of economically interrelated contracts between identical parties. However, inconsistent decisions can also affect parties that are not bound by the same arbitration agreement. The typical case is the relation between the contractor that is being sued by the principal for the performance of a subcontractor.

The contractor might be interested in introducing into the arbitration agreement clauses allowing some degree of participation by the subcontractor in the event of a dispute. By coordinating this language with the terms of the dispute resolution chapter of his agreement with the subcontractor, the contractor expects to make sure that the award or the findings, at least, are binding on the subcontractor.

There are two basic variations to this situation:

(1) The agreement with the principal provides for the possibility of extending the arbitration agreement or allowing a certain degree of participation in the arbitration procedures to certain third parties. In that case, the contractor must coordinate such language with the terms of his contract with the subcontractor; or

(2) The agreement with the principal does not provide for the participation of third parties. This is a very undesirable situation for the contractor, who may want to consider establishing in the contract with the sub-contractor that the findings from the arbitration with the principal shall bind the subcontractor. This has obvious inconveniences, e.g., arbitration is confidential.

### 5. Evidence and Other Procedural Matters

Parties can include in the arbitration clause the evidence rules that they feel comfortable with. They can provide for discovery, cross examination, or any other kind of procedural matter.

In the absence of an explicit agreement between the parties with regard to the production of evidence or of a set of rules, e.g., IBA rules on the Taking of Evidence in International Arbitration, the chances of obtaining discovery will largely depend on the procedural rules and practices of the place in which the proceedings are being held. While parties may obtain extensive discovery from English or American courts, this should not be relied on if arbitration takes place in civil law countries.

It should be noted, however, that Common Law lawyers should expect resistance from their civil law colleagues with regard to the convenience of providing for discovery in an arbitration agreement. Civil law educated lawyers generally believe that discovery generally serves the purpose of creating confusion and raising costs. In their view that justice will be better served if it is acknowledged, as then the parties tend to behave strategically to win the case rather than assuming that they will help the adversary to do so.

### 6. The Importance of the Seat of the Arbitration

Paris is supposed to be one of the capitals of international arbitration. The fact that the ICC International Arbitration Tribunal is established there may influence this. The prestige of Paris in international arbitration has more to do with a long-standing friendly legal environment, based on a very good arbitration regulation, non-interventionist local courts used to dealing with the intricacies of the subject, and experienced professionals.

It is true that if the parties do not provide in the arbitration clause for the location of the proceedings, or if they cannot agree on the subject once the conflict has

# CHAPTER 21
# DISPUTE RESOLUTION AND CONSTRUCTION CONTRACTS

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## A. INTRODUCTION

One similarity between the medical and legal professions is that prevention is better than cure. Preventing a potential dispute arising is preferable to having to resolve it.

Sensible drafting of contracts and full commercial advice to clients as to the substantial and varying risk involved in international projects may prevent disputes arising and, ultimately, this is in the client's best interests. Often there is a "cheese paring" of costs at the negotiation stage of a project, in that detailed advice has not been taken and advice has not been taken from all professionals.

However, disputes may well arise even after a well-negotiated and considered contract. The distinguishing feature between infrastructure project contracts and disputes arising from them, and the general run of contractual disputes, is that there are many interlocking and related contracts that form the project in question. Any discussion of dispute resolution must take into account this relationship. It is worth considering the possible interlocking disputes which could arise.

## B. WHAT DISPUTES MAY ARISE

### 1. Delay

Delay in the construction of the facility under a Build Operate Transfer (BOT) project directly affects parties to the construction contract, i.e., the project company and the construction contractor. It also affects the operating company, which is delayed in providing its services to users and the supplier from supplying materials. Due to the resulting delay in gaining revenue from the users, the delay will also affect the financing of the project.

Therefore, Power Purchase Agreement (PPA's) and other similar agreements strictly regulate the effects of delay in the commercial operation date and provide for liquidated damages in the event of a delay. However, the delay of a contractor in

the construction of the facility may have been caused by delays of the government in the performance of its obligations under the concession agreement, or of the power purchaser, who may have required changes in the supply parameters. As a result, the issue of delay, and its causes and consequences, must be considered in the context of the construction contract, the concession agreement, the PPA, and other contracts.

### 2. Quality or Availability of Service

A dispute between the project company and the user over the quality or availability of the service may also concern the operating company, the supplier of the raw materials or fuel, the lenders (preoccupied about the revenue which guarantees the service of their loans), and the sponsors.

The dispute may have its origins in a change of technical or safety regulations, labor legislation, or other matters, which may or may not be covered by the concession agreement with the government.

### 3. Financial Issues

Unexpected rates of inflation or a deterioration of the exchange rate may also detrimentally affect the project company, lenders, export risk insurer, sponsors, and other parties concerned with financial implications of the project. The parties may seek recovery through the rates or prices agreed or posted for the off-take or services of the facility. PPAs and financing arrangements usually contain provisions in this respect.

Lenders in certain projects that include long-term supply contracts, such as the PPA in power generation projects, enter into subrogation or similar agreements with the power purchaser, often described as "direct agreements". Under these agreements, the lender may, directly or through another company, assume the rights and obligations of the project company in case that company fails its obligations under the PPA, and the power purchaser, on these grounds, would be entitled to terminate the PPA.

## C. CONSIDERATION OF A PROJECT DISPUTES RESOLUTION CLAUSE

It must be considered whether it is possible to create an overall contract disputes resolution clause in the same manner as a project insurance clause to which everyone must subscribe and be bound by. In practical terms, it is unlikely to be possible.

The disparate interests are fairly entrenched and include financiers at one end of the spectrum and specialist suppliers at the other end. They are unlikely to accept any one method of dispute resolution, however attractive the theory might be. The remaining sections will review how to resolve disputes under the construction contract itself.

## D. RESOLUTION UNDER THE CONSTRUCTION CONTRACT

### 1. Construction Contract

The key contract in any infrastructure contract is the actual construction contract. Regardless of other issues, the contract will fundamentally address issues on:

(1) Time;

(2) Estimated price; and

(3) Correct quality.

Any dispute resolution procedure on the construction contract ought to satisfy as many as possible of the criteria as set out below.

### 2. Criteria for Dispute Resolution Procedures

The criteria for a dispute resolution procedure are:

(1) Any procedure must have, as its main objective, a speedy resolution of a dispute, whether during or after completion of a project, and in an as non-adversarial manner as possible so as to enable the parties to maintain a commercial relationship;

(2) Any procedure during the execution of a project must allow the project to proceed without irreparable damage to the parties' position;

(3) Any procedure after a project has been completed must be within the time and cost specified limits and avoid an extended appeal process;

(4) Any procedure must accept that a serious problem may arise during the execution of the project;[1]

(5) Procedures must be such so as to encourage an amicable resolution between the parties but also should not allow any cooling-off period to be used as a lever by one party against the other;

(6) Procedures should, as far as practicable, be capable of being used or adopted for use in the family of contracts created by an international project, given the interlocking nature of contracts to which has been referred to above; and

(7) Procedures should be considered international and reflect the nature of the contract, and thus be reflected by the law and language of the contracts.

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[1] Accordingly, procedures that prevent a party from raising a dispute until after completion of the project rarely operate in the long-term interest of any party. Therefore, procedures must be capable to immediately review an urgent problem in a practical nature.

## E. FEDERATION INTERNATIONALE DE INGENIEURS CONSEILS CONTRACTS

### 1. Clause 20

The 1999 revision of *Federation Internationale de Ingenieurs Conseils* (FIDIC) contracts contains a detailed dispute resolution procedure at clause 20. In fact, clause 20.1 relates to claims which are a sensible precursor to the dispute resolution clause in that, if a claimant has not complied with the notice procedure as set out in clause 20.1, then it is arguable that a dispute has not yet arisen.

Assuming that a dispute has arisen, clause 20.2 requires that a dispute is referred to a Dispute Adjudication Board (DAB) which consists of one to three members. Detailed provisions are contained in clause 20.2 for the manner in which DAB members are to be appointed, and appendix I and its annex have provisions on the operation of the DAB.

### 2. Dispute Adjudication Board or Dispute Review Board

The system of a Dispute Adjudication Board (DAB), which is advocated by the FIDIC, should be distinguished from a Dispute Review Board (DRB), as advocated by the World Bank. The basic difference between the two systems is that the DAB renders a decision as immediately binding on the parties regardless of whether one party is dissatisfied with the decision. Whilst a DRB merely issues a recommendation, if one party is dissatisfied with the recommendation, then that party is not under any obligation to implement the recommendation.

All three 1998 test editions were published by the FIDIC (Red for Construction, Yellow for Plant, Silver for BOT), provided that disputes had to be referred to a standing DAB. The DAB was a standing board in the sense that it would be formed at the signature of the contract and would remain in place continuously until the works had been completed. Typically, this would mean that the DAB would be in place for a period of years, the exact length depending on the duration of the particular project.

However, on reflection, the FIDIC concluded that, at least in the case of a new Plant and Engineer Procure Construct (EPC) Contracts, it would be more appropriate (and less expensive for the parties) to provide in the general conditions for an *ad hoc* DAB. This would be a DAB which would only need to be constituted if and when a dispute or disputes arose and would cease to operate once a decision on such a dispute or disputes had been issued. The main reason for a standing DAB is to deal with disputes on or related to the construction site.

However, when the contract mainly addresses issues for the design and manufacture of electrical or mechanical equipment in a factory rather than construction work on the site (as happens in many projects for which the new plant and EPC Contracts are used), it is difficult to justify the time and expense of maintaining a

a standing DAB. Accordingly, the FIDIC has opted for an *ad hoc* DAB in the general conditions for these types of contracts.

It must be said that each system has its merits and demerits, and it must be for the adviser at the pre-contract stage to review the same with his client regardless of what FIDIC form is used. On the side of benefit of the FIDIC Yellow and Silver Book methods must be flexibility in that the party appointee can be tailored to the nature of the dispute that has arisen. Further, no costs are incurred unless and until the appointment must be made.

### 3. Disadvantages of a Dispute Adjudication Board

The disadvantages of a Dispute Adjudication Board (DAB) are:

(1) The assembly of a DAB could be quite lengthy, particularly if one party is less co-operative than the other;

(2) Newly appointed DAB members may not immediately be familiar with the site or the "history" of the project;

(3) Clause 20.3 contains provisions in the event that a DAB is not agreed;[2]

(4) The FIDIC procedures require a party in almost every circumstance to obtain the DAB decision as a pre-requisite to the ability to commence an arbitration;

(5) The FIDIC procedures direct the parties to try and settle a matter amicably between the DAB decision and arbitration;[3]

(6) There is no provision in the contract for mediation, alternative dispute resolution, or similar;[4] and

(7) Clause 20.6 provides for arbitration with a full power in the arbitration to open up and review the contract.[5]

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[2] Although these are adequate, it also provides opportunities for delay. The period of 28 days must elapse before an application can be made to the appointing body for an appointment, and there will no doubt be further delay while the appointment is made.

[3] The procedures do not contain a compulsory "cooling off" period before initiating the DAB. Previous editions of the FIDIC, e.g. clause 67.2 of the *Red Book*, 4th edition, did have such a period before arbitration could be commenced. The "cooling-off" period was mostly likely abandoned because it was used as a delay tactic.

[4] Curiously, the FIDIC Client/Consultant Model Services Agreement, revised in 1998, contain a detailed mediation procedure to be followed before arbitration can be commenced.

[5] Arbitration may be commenced at any time provided that the DAB procedure has been followed.

## F. NEW ENGINEERING CONTRACTS (NEC)

### 1. Adjudicator

The core clauses of New Engineering Contracts (NEC) (Clauses 90–93) require any dispute to be referred to and settled by an adjudicator. An adjudication table sets out what can be submitted to an adjudicator and when this can be done. Clause 90 in the NEC does not, however, provide a mechanism for appointing an adjudicator. The Contract Data will contain provisions for naming the adjudicator. The parties also enter into a separate contract with the adjudicator called the adjudicator's contract. Problems may arise if:

(1) The named adjudicator may have substantially different qualifications from those needed to deal with the dispute that in the event has arisen; and

(2) Only the contractor has the right at tender stage to object to the identity of the adjudicator.

Only the contractor can raise issues about action or inaction by the project manager or supervisor and refer them to the adjudicator; so the employer's position may be prejudiced without adequate remedy except in arbitration after the event.

Clause 90.2 allows the parties to insert a time within which the adjudicator must reach his decision. Again, this is negotiated at tender stage. By Clause 92, the adjudicator's decision is enforceable as a matter of contractual obligation between the parties and not as an arbitral award. His powers include being able to revise any action or inaction of the project manager or supervisor.

It must, however, be a matter for argument as to what "enforceable as a matter of contractual obligation" means. Does this, for instance, mean that, although there is a power in the tribunal by clause 93 to review any adjudicator's decision, the decision must be given full effect in the meantime. If one party ignores the decision, what are the other party's remedies?

### 2. Clause 93

Clause 93 provides the mechanism for forming a tribunal. The parties are free to choose their own forum. This could, and usually does, mean arbitration. However, the looseness of the wording and the option given has lead to argument that there is no valid reference to arbitration.[5]

Two further matters arise from clause 93. Firstly, the tribunal's powers only arise after the adjudicators' powers have been exhausted and no reference can be taken before completion of the works or termination. This is when there is no express provision for mediation or alternative dispute resolution.

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[5] Cornes, 1996 *International Construction Law Review*, at p.110.

Secondly, the first edition of NEC contained a provision by clause 92.3, which might have made a dispute under any subcontract possible of joinder under the main contract. At that stage the forum for resolution of disputes was arbitration; now it is a tribunal. No similar provision to clause 92.3 appears in the second edition, although, strangely, in the NEC sub-contract, there is a provision for a possible tripartite arbitration. As there is no similar procedure in the main NEC contract, it is hard to see how, without express agreement of the employer either to a tripartite arbitration, or reference to the same adjudicator, the sub-contract procedure can have any effect.

The avowed aim of the NEC contract is flexibility. While this can be understood, several of the uncertainties created cause considerable concern.

## G. CONCLUSION

An assessment of the criteria as mentioned at D.2., above, in the context of FIDIC and NEC contracts follows:

| **Criteria** | **FIDIC** | **NEC** |
|---|---|---|
| 1. Speedy resolution in non-adversarial manner. | If standing DAB can proceed, if not possible then delay. DAB likely to be balanced with a Chairman to assist members. No provision for mediation pre-DAB. | Adjudicator named in contract, which may not be suitable. Two-stage process with no provision for mediation. |
| 2. Enables project to proceed. | Can take place during contract, possible scope for discussion and resolution. | Obligatory, so possible prejudice. No adjudication until completion or abandonment. |
| 3. Limitation on appeal process. | None. | None, choice of Tribunal could affect this. |
| 4. Execution of project not with irreparable damage to one party. | See 2, above. | See 2, above. Party must proceed regardless of problem. |
| 5. Encourages amicable settlement. | 3 person DAB may. Provision for amicable settlement between DAB and Arbitration. | None expressly. |
| 6. Adaptability to overall matrix of contract. | Possible if *ad hoc* DAB used. No provision for joinder. | No provision for joinder. |
| 7. Procedures to be international but reflect law of country and works. | ICC Arbitration and scope in DAB process. | Choice of Adjudicator and Tribunal critical. Would need to expressly provide that ICC applies. |
| **Overall** | Decision to be made on whether *ad hoc* or standing DAB. | Flexible but needs very careful thought at pre-contract stage. |