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The Role of the Lender's Direct Agreements in the Project Finance Transactions – Can Financial Institutions Effectively Shield Themselves from the Unexpected Events?

Abstract:

Risk management is one of the key issues in the preparation and implementation of public-private partnership projects. In particular, the issue of risk management pursued by banks financing the project is of paramount importance. One of the instruments allowing banks to avoid unforeseen circumstances under the project finance are direct agreements, which give banks the option of taking over SPV contracts in the event of a significant threat to their implementation, in order to find a quick solution to the problem, without the need to terminate the contract (step-in rights). It is even more important when we consider project finance transactions where great amount of money is involved and where whole transaction is based on the projected cash flow of the finished project, rather than the investors' own finances. As such, with the so-called direct agreements, banks are trying to outline the legal responsibilities of the parties in order to secure for themselves control over transaction. Provided that this solution is effective, it leads to high financial stability of projects.

Key words: risk management, public-private partnership, direct agreements, contract

Introduction

The issue of project finance transactions in the context of infrastructure projects launched by public and local entities has been the subject of lively debate among international legal environment. And this is not surprising, as the issue has great practical

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significance, and experience shows that most projects in which a public entity is involved, must confront the financing boundaries, which could be solved probably only through the medium of public finance.

Notwithstanding the above, project finance transactions do not provide perfect solutions. The devil is in the details. The project finance imposes a several risk on lenders (financial institutions), whose role is inevitable in project finance transactions. The lender is generally concerned with the economic value of the project, the legal adequacy of the contracts and enforceability of the contracts in a loan workout scenario[2]. This issue is even more serious in states where the law does not provide specific answers for the question of responsibility in the context of public-private partnership (PPP) based on project finance. Thus, the parties do not have a clear understanding of what obligations and liabilities they may be assuming in connection with the project and therefore, they are not able to consider appropriate risk-mitigation exercises at the relevant time. However, again, the practice in project finance provide adequate legal instrument confronting these issues. One of the typical features of a lender security package on a project financing is the direct agreement. Its main aim is to provide lender a certain security package should the project get into trouble. It enables the lenders to step into the shoes of the project company and take over the project (step-in right) or find a substitute entity to continue the project. However, these great rights provide some difficulties as they, ultimately, put the other parties at the significant disadvantage.

Thus, in the light of the above, the aim of this paper is to examine what is the role of the direct agreements in the project finance transactions? Do these agreements effectively secure the lender's interests? Answers for these questions require very careful analysis of project finance transactions within the context of the economic and legal environment.

Firstly, I briefly demonstrate what the project finance, in light of which the direct agreements are concluded, is. Secondly, I illustrate the direct agreement as a one of the instruments of lenders' security protection. Thirdly, I examine the role of the direct agreements with respect to project finance transactions. Although, it seems that these agreements are inevitable in project finance transactions, their conclusion often involves serious issues, which parties must overcome. Lastly, I provide conclusion and major thoughts of this paper.

What is the project finance?

Before we analyze the nature of direct agreements, it is essential to move back to its context, namely the project finance. What is 'project finance'? The term features prominently in the press, more specifically with respect to infrastructure, public and private venture capital needs. The press often refers to huge projects, such as building infrastructure projects like highways, metro systems, or airports.

[2] A. Fight, *Introduction to Project Finance*, Oxford 2006, p. 46–47.

Project finance is generally used to refer to a non-recourse or limited recourse financing structure in which debt, equity and credit enhancement are combined for the construction and operation, or the refinancing, of a facility in a capital-intensive industry[3]. Credit appraisals and debt terms are typically based on project cash flow forecasts as opposed to the creditworthiness of the sponsors and the actual value of the project assets[4]. Forecasting is therefore at the heart of project financing techniques. Project financing, together with the equity from the project sponsors, must be enough to cover all the costs related to the development of the project as well as working capital needs[5]. In other words, project finance is a technique that has been used to raise huge amounts of capital and promises to continue to do so, in both developed and developing countries, for the foreseeable future.

Project finance transactions are complex transactions that often require numerous players in interdependent relationships. For this paper, the transaction in question would be simplified and limited to three main actors: lender, borrower, third party.

The large size of projects being financed often requires the syndication of the financing. For example, the Eurotunnel project financing involved approximately 220 banks[6]. The syndicated loan exists because often any one lender individually does not have the balance sheet availability due to capitalization requirements to provide the entire project loan. Other reasons may be that it wishes to limit its risk exposure in the financing or diversify its lending portfolio and avoid risk concentration. The solution is to arrange a loan where there are several lenders (banks and other financial institutions) forwarding funds under a single loan agreement. Such a group of lenders is often called a syndicate[7]. A syndicate of banks might be chosen from as wide a range of countries as possible to discourage the host government from taking action to expropriate or otherwise interfere with the project and thus jeopardize its economic relations with those countries. The syndicate can also include banks from the host country, especially when there are restrictions on foreign banks taking security in the country.

The borrower is usually the project company. The project company is the legal entity that will own, develop, construct, operate and maintain the project[8]. The project company is generally a special purpose vehicle (SPV) created in the project host country and therefore, subject to the laws of that country[9]. The SPV will be controlled by its equity owners. And it is formed specifically to build and operate the project. It enters into contractual agreements with a number of other parties necessary to the project.

Finally, the third party is the project sponsor – the entity that manages the project. The sponsor generally becomes equity owner of the SPV and will receive any profit

[3] *Ibidem*, p. 1.

[4] D.F. Pretorious, *Project Finance for Construction and Infrastructure*, Blackwell 2008, p. 6.

[5] A. Fight, *op.cit.*, p. 1–2.

[6] E.S. Gatti, *op.cit.*, p. 63.

[7] A. Fight, *op.cit.*, p. 20.

[8] *Ibidem*, p. 11.

[9] *Ibidem*, p. 12.

either via equity ownership or management contracts[10]. The project sponsor generally brings management, operational, and technical experience to the project. The project sponsor may be required to provide guarantees to cover certain liabilities or risks of the project[11].

As we can see, the complexities of project finance are such that the project parameters and interrelations need to be managed within a clear framework, which is formalized via contracts. Project finance can therefore, be subject to numerous subcontracts within the overall framework of the project financing.

Each project finance participant has a different perspective on risk, often based on the role it is playing in the overall project financing structure. This perspective will obviously impact the participant's appetite for risk. The view of risk moreover is subjective and based not only on economic factors but on characteristics relating to the financial condition of the participant. A particular risk, event or condition that is unacceptable to one party may be considered manageable and routine by another. The identification of risks and knowledge of the participants is therefore, essential if a project financing is to be assembled successfully. Since this paper is primarily focused on lender's direct agreements, we will therefore consider the risk from perspective of a lender as a participant in a project financing.

The lender is generally concerned with the economic value of the project legal adequacy and enforceability of the contracts in a loan workout scenario. Overall, the lender attempts to structure financing that ensures all costs before construction completion are without recourse to lender for additional funds. Moreover, that the contractor satisfies performance guarantees, as evidenced by performance tests. There is recourse to other creditworthy project participants for delay and completion costs if the project is abandoned and if minimum performance levels are not achieved. There are predictable revenue streams that can be applied to service debt. The revenue streams are long term, from a creditworthy source and in an amount that covers operating costs and debt service (e.g. an off-take agreement). The project maximizes revenue while minimizing costs, complying with environmental laws (or lobbying to obtain exemptions) to maintain long term viability.

Since typically the lenders will have no recourse to assets of the project company (other than the project assets) and will look primarily to the cash flow generated by the project to repay loans to the project company, it is therefore essential that lenders ensure that valid and effective security interests are taken over all the project assets[12]. Moreover, it is essential that lenders fully understand the local legal system and how enforcement of security may not be as satisfactory as that in their own home systems. If problems do arise with the project and the lenders are forced to pursue their security interests then, in the absence of any shareholder guarantees or other tangible support, the enforcing of their security over the project assets will be the only opportunity for the lenders to recover their loans.

[10] *Ibidem*.

[11] *Ibidem*.

[12] *Ibidem*, p. 73.

Lender's direct agreements

As we can see, well-structured legal relationship is of paramount importance in project financing. The nature of project finance is such that the list of project contracts is a closed one, in theory. In fact, the project company cannot have any relationship or responsibility that is not strictly associated with structuring the project finance, in financial and legal terms[13]. Lenders are not parties to these contracts but acquire certain rights as regards these agreements through the security documents (either by pledging or assigning the credits deriving from these contracts by way of security).

Where the lender wishes to take the collateral benefits to other agreements and contracts, it may be necessary for it to become a party to security documents. Naturally, the lender wishes to pick up all the rights and interests without any obligations. That is seldom possible. For instance, to establish a legal charge over a borrower's interest under the unincorporated joint venture (UJV), the banks will seek to step into the rights of their borrower in the UJV[14]. However, under the cross-charging provisions in a typical UJV, each party charges the others' revenues to pay operating costs that have not been paid by the other parties – a double-edged sword[15]. Thus, in project finance like in any other transaction there is no absolute solution in establishing security that would cover lender's interest completely. Nevertheless, in project finance transactions over 30 years banks have been parties to specific security arrangements that are called 'direct agreements'[16].

Direct agreements are recognized as a normal part of a project security package in standard practice. Most of these contracts, and the most substantial part of the contents of each, address situations where the project is in difficulty. As such, these agreements are part of the security package[17]. Though direct agreements do not technically constitute security interests, the function of these agreements is strictly related to that of security interests and remedies available to lenders in case of a crisis of the project. Understanding these agreements is essential to getting a true picture of the project in case of default as well as lenders' step-in rights.

As it was mentioned in the introduction, project finance risks are highly specific and it is essential that participants such as commercial bankers, investment bankers, general contractors, subcontractors, insurance companies, suppliers and customers understand these risks since they will all be participating in an interlocking structure. These various participants have differing contractual obligations, and the resultant risk and reward varies with the function and performance of these various parties[18]. Ideally, the debt servicing will be supported by the project cash flow dynamics as opposed to the participants, who at best provide limited coverage.

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[13] E.S. Gatti, *Project Finance in Theory and Practice*, Elsevier 2008, p. 240.

[14] R. Tinsley, *Advanced Project Financing: Structuring Risk* (2nd Edition), Euromoney Books 2014, p. 384.

[15] *Ibidem*.

[16] G.D. Vinter, *Project Finance* (3rd Edition), Sweet & Maxwell 1998.

[17] E.S. Gatti, *op.cit.*, p. 272.

[18] A. Fight, *op.cit.*, p. 1–2.

A project is financed without recourse not because it has an existing credit capacity, but because the initiative is set up to be bankable in light of particular conditions on the basis of the project finance technique[19]. Project operations and the resulting revenues are the only source of loan reimbursement. If these are threatened, the chances of paying back the loan exclusively with the project company's resources are likewise jeopardized. Thus, due to the peculiarities of project finance, lenders find themselves in a rather weak position in the face of financial difficulties that the project company may come up against. This is true despite the impressive system of contract solutions and security interests that lenders can rely on. Since banks are not generally equity risk takers, the means available to enhance the credit risk to acceptable levels are limited, which results in higher prices. This also necessitates expensive processes of due diligence conducted by lawyers, engineers and other specialized consultants[20].

Direct agreements emerge as the concrete solution available to lenders in case the project faces a financial crisis. Direct agreements are contracts executed directly by the lenders and the key counter parties to the project agreements. Like reserved discretions, direct agreements can be numbered among the legal instruments that lenders use to reserve the right to interfere directly in the relationship between the project company and third parties[21]. Bearing this out, customarily the third party in direct agreements recognizes that the project company is given certain discretions in the contract in question that are subject to the control or approval of lenders.

Typically, the purpose of direct agreements is twofold: to safeguard the project agreements, on one hand, and to establish a sort of lenders' right to „takeover" these agreements on the other[22].

Moving to the first one it is essential to address the question of bankability. In order for an investment initiative to be structured on the basis of project, one requirement is a bankable project contracts. In other words, these contracts must be compatible with the goals and the features of the financing, in economic and legal terms. The project has to be „structured" on the basis of contractual relationships having certain distinctive legal and economic features, which have to protect the project company and its expected revenues. If the project agreement system adequately safeguards these expectations, the project is a suitable candidate for project finance. On the other hand, losing project contracts (which can happen in case of termination due to default by the project company) means jeopardizing the bankability of the project.

This explains why lenders want to be able to intervene directly with respect to third parties to project agreements if the project company risks losing these contracts due to its own nonperformance or for any other reason. Provisions in the project contract to which the direct agreement in question refers have the purpose of mitigating the risk of termination because of default by the project company. In addition to these, the direct agreement normally gives lenders the right to be informed directly about any

[19] E.R. Yescombe, *Principles of Project Finance*, WoltersKluwer 2007, p. 134.

[20] A. Fight, *op.cit.*, p. 45.

[21] B.J. Dewar, *International Project Finance – Law and Practice*, Oxford 2011, p. 158.

[22] E.S. Gatti, *op.cit.*, p. 241.

circumstances that would justify terminating the contract. Lenders are also entitled to intervene to remedy the default situation to prevent termination of the relevant contract. In some instances, this contract may go so far as to include the possibility of nominating an additional party who would assist the project company in contract execution and take on the relative obligations, on either a temporary or permanent basis[23].

Clearly, these rights can be explained in the context of a critical situation for the project company. Lenders reserve the option to help the project company overcome such a contingency rather than allowing the crisis to deepen and cause the project irreparable damage.

The second function of direct agreements relates to the enforcement of security interests, which can be explained in the context of a characteristic feature of project finance: step-in rights of project lenders. Under certain conditions specified in the direct agreements, lenders can replace the project company with a third party as counter party to the project agreements[24]. These conditions usually entail circumstances that would justify terminating the relevant contract due to default by the project company or situations that would entitle lenders to enforce their security interests[25].

The purpose of these provisions is clear: Lenders reserve the right to replace the project company with a different party in the project contracts both to prevent the possibility that a default by the project company may trigger termination and to take control of the project if the need should arise. This would be the last possible resort in the face of a financial crisis. Lenders demand the right unilaterally to „divest" the project company of the project agreements. This occurs in light of the possibility that lenders may find themselves forced to dispossess the borrower from the entire project to take over control and operations.

Lender's direct agreements and security interest

As we can see, a project is financed without recourse not because it has an existing credit capacity, but because the initiative is set up to be bankable in light of particular conditions on the basis of the project finance technique. Project operations and the resulting revenues are the only source of loan reimbursement. If these are threatened, the chances of paying back the loan exclusively with the project company's resources are likewise jeopardized.

Due to the peculiarities of project finance, lenders find themselves in a rather weak position in the face of financial difficulties that the project company may come up against[26]. This is true despite the impressive system of contract solutions and security interests that lenders can rely on. With corporate financing, there is a clear and unquestionable logic behind loan acceleration. If an event of default occurs that lenders deem sufficiently serious, acceleration allows them to collect their due from the borrower's

[23] B.J. Dewar, *op.cit.*, p. 250.

[24] *Ibidem*, p. 253; A. Fight, *op.cit.*, p. 50; E.R. Yescombe, *Principles*…, p. 134.

[25] E.S. Gatti, *op.cit.*, p. 272.

[26] *Ibidem*, p. 273.

resources in advance, before these funds are lost or paid out to other creditors[27]. In other words, we can say that in normal situations, the borrower has the capacity to repay its debts, or, in other words, its financial resources are greater than its debt vis-a`-vis the lenders. Consistent with this, the contractual system of the financing includes provisions that allow lenders periodically to monitor this situation.

In project finance, the acceleration solution is an illusory one. Most of the project company's resources are applied in repayment of the loan. The account structure mechanism is well suited to ensuring that liquidity available to the project company is channeled to repay lenders, except that which covers the costs essential to the survival of the project and the company. Acceleration of the loans does not generate the financial resources needed to repay the loan, and the project company does not have any reserve funds that it would have to pay immediately to lenders in case of acceleration[28].

The option of enforcing security interests is also illusory, if taken in the traditional sense. To benefit from security means to have the right to sell the secured item and keep the proceeds of the sale. The beneficiary of security has priority over the asset and then proceeds from the sale of the asset itself. All this makes sense if the security in question has its own independent value and was secured based on that value. In project finance, the perspective is completely different. Security is created on everything that has to do with the project[29]. The project has value only if it is up and running and can generate revenues, which are used to repay the project loan and to compensate sponsors. The individual economic value of the assets that are subject to security, if not negligible, is by no means commensurable to the amount of the loan. And this value shrinks even more if the project defaults, which is precisely when the question of enforcement comes in to play.

These are the reasons why step-in rights emerge as the concrete solution available to lenders in case the project faces a financial crisis. By means of the legal instruments provided in the finance documents (security documents and direct agreements), lenders are entitled to take control of the project to remedy or make arrangements to remedy the causes of the default situation, as far as possible. In the first and most common situation, this is implemented by appropriating voting rights relating to secured shares and replacing the board of directors, enforcing the security on the shares themselves, and, if necessary, taking ownership of the project company's share capital[30].

If lenders have completely lost control of the situation and the project company is subject to insolvency procedures, their position becomes more complicated. In this case, the security created directly over the company's assets takes on vital importance[31]. Step-in will probably be carried out by means of an agreement with the administrator in bankruptcy. The lenders represent most of the company's debts, but at the same

[27] *Ibidem.*

[28] *Ibidem*.

[29] *Ibidem*, p. 274; D.F. Pretorious, *op.cit.*, p. 155.

[30] E.S. Gatti, *op.cit.*, p. 274.

[31] G. Vinter, *op.cit.*, p. 149–150; P.R. Wood, *Project Finance, Subordinated Debt and State Loans*, Sweet & Maxwell, London 1995, p. 32.

time they have security interests on almost all the company's assets. Therefore, both in practice and in legal terms, they find themselves in an extremely peculiar position vis-a`-vis the insolvency procedure underway. Step-in rights provided for in the direct agreements again prove useful if a third party buys or rents the plant from the insolvency procedures, most likely with the lenders' consent. In this kind of situation, the project agreements can be assigned to the new plant operator and the project will have safeguarded some of its value. Only if there are no other possible solutions are security interests enforced in the traditional sense. Every single asset is sold for the highest possible price. But it is hard to imagine this kind of situation ever arising in the real world, since lenders are the ones who are most keen to avoid bankruptcy procedures for the project company.

Further, although, the direct agreements provide many controversies, this issue is even more complex if we consider the presence of local and regional self-government entities in the project finance transactions. Typically, public entities would participate in projects based on project finance in the form of public-private partnerships (PPP)[32].

Encouraging investors to use project finance for PPP projects may bring benefits to the public entities. For instance, the local entity may benefit from the independent due diligence and control of the project exercised by the lenders, who will want to ensure that the project is viable, and that all obligations to the local entity can be safely fulfilled. Project-finance techniques are based on risk allocation, and so this due diligence fits well with the overall philosophy of risk transfer which is one of the arguments for PPPs[33].

The involvement of third parties, especially lenders and their advisers, in a PPP structure, should therefore mean that a rigorous review of the risk transfer is carried out, and any weaknesses exposed, before the local entity has made a commitment to go ahead. However, this is only one side of the coin. It must be borne in mind that lenders will always want to ensure that project risks are taken primarily by subcontractors or the local entities rather than the project company, and so their objectives are not the same as those of the local entity. Moreover, lenders are frequently used as proxies by sponsors to re-open PPP contract negotiations[34]. In addition, once a PPP contract has been signed, project-finance lenders exercise continuing controls on the activities of the project company, thus helping to ensure that the requirements of the PPP contract are fulfilled. This control is typically fulfilled through the direct agreements described above[35].

Direct agreements are the basis for direct relations between the parties and also govern the mutual communication concerning the progress of the project, grounds for termination of PPP contract by a public entity or finally the parties obligations to take or refrain from certain actions[36]. For instance, these agreements could impose

[32] E.R. Yescombe, *Public-Private Partnerships, Priniples of Policy and Finance*, Elsevier 2007, p. 2.

[33] *Ibidem*, p. 120.

[34] *Ibidem*, p. 121.

[35] E.S. Gatti, *op.cit.*, p. 274.

[36] E.R. Yescombe, *Public*…, p. 113; D.F. Pretorious, *op.cit.*, p. 239.

the obligation on public entity to refrain from termination of PPP contract within the specified time, while the lender will try to remedy the consequences of default. What is more, the total income means all long-term obligations even if there are not due in that year. However, direct agreements could be shamefully long[37]. There are examples of direct agreements which are longer than project agreements to which they relate. Thus, the shorter the agreement the more likely is to be acceptable by a third party and to the extent that some superfluous bells and whistles can be removed from the draft document which is sent to the third party, and the easier the negotiation process will be.

Conclusion

As far as banks are concerned, a direct agreement can be said to perform both a defensive and an aggressive function. It performs a defensive function as it protects the banks against a precipitous termination of a project contract by the other contracting party. On the other hand, it allows the banks to seize control of the project company's rights under the project contract.

It could be argued that the practical value to the lenders of many of the provisions of direct agreements is questionable. Moreover, third parties, especially in the public sector, are often reluctant to sign such agreements due to risk allocation. The project company clearly has little interest in them, since the direct agreements effectively cut the project company out of the picture once it is in default and create a direct relationship between the lenders and the project contract counterparts. However, from the lenders' point of view probably the most important point is that the real value of their security lies in the project contracts, and direct agreements may help them to step rapidly into the into the picture after a project company default to preserve these contracts and find another party to take them over.

Further, direct agreements involving local and regional self-government entities could play an essential role not only in securing lender's interest but also in developing PPP. This is because the aim of these agreements is to ensure that the underlying project document remains in place throughout financing and the local entity keeps performing even if the project company defaults or the bank enforces its security.

To conclude, despite the abovementioned controversies, direct agreements continue to play a vital role in a lenders' security package, and with some critical thinking form the lender, borrower and local entity at an early stage, the process of obtaining them can be made fairly painless and beneficial.

[37] G. Vinter, *op.cit.*, p. 276.

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Rola pożyczkodawcy w umowach bezpośrednich w ramach transakcji finasowania projektu. Czy instytucje finansowe mogą skutecznie chronić się przed nieprzewidzianymi zdarzeniami

Zarządzanie ryzykiem jest jednym z kluczowych zagadnień w przygotowaniu i realizacji projektów partnerstwa publiczno-prywatnego. W szczególności ogromne znaczenie ma kwestia związana z zarządzaniem ryzykiem podjętym przez banki finansujące projekt. Jednym z instrumentów pozwalających bankom uniknąć nieprzewidzianych okoliczności w ramach project finance są umowy bezpośrednie (direct agreements), które dają bankom możność przejęcia kontraktów spółki SPV w razie istotnego zagrożenia ich realizacji, w celu znalezienia szybkiego rozwiązania problemu bez konieczności wypowiedzenia umowy (step-in rights). Ma to tym większe znaczenie, biorąc pod uwagę fakt, iż w ramach project finance, gdzie często zaangażowane są znaczne kapitały, cała transakcja opiera się na przepływach pieniężnych z ukończonego projektu, a nie środkach finansowych inwestorów. W związku z tym, banki poprzez umowy bezpośrednie, które określają zakres odpowiedzialności stron, zapewniają sobie kontrolę nad przebiegiem transakcji. Efektywnie sprawowana kontrola prowadzi zaś w rezultacie do stabilności finansowej projektu.

Słowa kluczowe: zarządzanie ryzykiem, partnerstwo publiczno-prywatne, kontrakty, umowy bezpośrednie