International project financing as contractual risk minimization arrangements

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1. INTRODUCTION

1.1. Overview of project financing

The term "project financing" has been used in various meanings describing the financing of any project through any funding sources and through any risk assumption pattern. In the field of international development aid, for example, project financing means lending for a specific project in which the lenders have a direct and unlimited recourse to a corporate or governmental borrower. Thus, the technical or economic success or failure of the project is important, but not decisive for the lenders, because they have access to the borrower's non-project assets and revenues which can be used for the repayment of the loan.\(^1\) In the field of commercial banking, however, the terms "project financing" and "project lending" have become commonly known by definition as \textit{lending to a project} (typically to a sole purpose project company) in which the lender expects to be repaid principally from the cash flow generated by the operation of a particular self-liquidating project. The sole collateral for the loan are the revenues and assets of the project, except for limited recourse to the project sponsors, i.e. equity owners of the project or other parties supporting it.\(^2\) In other words, project financing means finance which is raised on a limited or non-recourse basis where debt servicing and repayment largely or solely depend on the project's cash flow.

In the context of project financing, the term "project" refers to the process of planning, constructing and operating of an income-producing economic unit. Typically, various project financing techniques have been used to finance e.g. mines, pipelines, telecommunication networks, power plants, mineral processing plants, and other industrial enterprises. During the course of privatization in recent years, the applications of project financing have become more and more common in financing large-scale infrastructure projects like bridges, tunnels, railroads and highways.\(^3\)

International project financing arrangements usually involve the establishment of an independent legal entity by the project’s sponsors in the


\(^2\) Harries 346.

project's host country. The legal form of the entity is often a limited liability company or a company limited by shares for risk limitation and risk-sharing purposes among the participants of the project. This project company owns the project assets and is charged with the construction and operation of the project. In project financing arrangements, the project company is liable to the project lenders for the repayment of the loans. From the project sponsors' perspective, the project company serves as a risk limitation unit between them and the project lenders.\(^4\)

Project financing arrangements often make the financing of large-scale infrastructure projects commercially feasible by minimizing the risks which the parties involved must bear. Typical risk groups frequently existing in almost all international projects are completion risks, operation risks, market risks and political risks.\(^5\) The objective in the project financing arrangements is the transferring, allocating and sharing of risks among the various parties in a project, e.g. the project company's shareholders, contractors, equipment suppliers, energy and raw material suppliers, buyers of the project's end product, and project lenders. As a result, the risk level of each party should be financially reasonable in comparison with the future benefits to be achieved by the implementation and operation of the project.\(^6\)

The minimizing of project risks by transferring, allocating and sharing them between the parties of a project can be achieved by contractual arrangements, which are often very complicated. These contractual arrangements include special loan agreement provisions, various types of loan guarantees, long-term sales and purchase obligations, and other basically legal instruments allocating rights and obligations between the parties. As the large-scale investment projects financed by project financing are often crucial for the project's host country, it is justifiable to say that project financing represents an essentially legal solution to some of the major problems in financing.


\(^5\) Harries, 348-350.

economic development.\textsuperscript{7}

1.2. The basic structure of project financing arrangements

There is no uniform model for project financing arrangements. Each project financing is structured on a case-by-case basis, in accordance with the specific needs of the project. However, the basic structure of project financing typically contains the elements set out in the following example:\textsuperscript{8}

1) A single purpose project company (typically a limited liability company or a company limited by shares) is formed in the project's host country to build and operate a project. The shares in the project company are owned by the project sponsors who enter into a shareholders' or joint venture agreement with each other, governing their rights and duties as shareholders. The sponsors invest a certain amount of capital in the project company by way of equity subscriptions and/or subordinated debt.

2) In case of a major project, the government of the project's host country grants a concession to the project company to build and operate the project.

3) Project contracts are entered into between the project company and the parties interested in the project. By entering into a construction contract, a contractor agrees to construct the project. The contractor's obligations are frequently bonded by surety companies or banks. The project sponsors may give a completion guarantee to the project company, guaranteeing that completion will take place at a certain date. There may also be equipment supply contracts whereby manufacturers agree to supply the equipment for the project. Moreover, energy and/or raw materials supply contracts are entered into between the project company and the suppliers. Finally, a long-term sales and purchase agreements may be entered into between the project company and the purchasers. Here, the purchasers (who often may be project sponsors) agree to buy all the project's production, or a certain portion of it.

\textsuperscript{7} Rauner, 145.

\textsuperscript{8} This example is based on the description in Wood, Project Finance, Subordinated Debt and State Loan, 3 and 4.
4) A syndicate of banks enters into a credit agreement (loan agreement) to finance the construction of the project. The borrowing entity is the project company. The project company grants the project lenders the maximum security available over the project assets. Before the disbursement of the loan, the project lenders require, as a conditions precedent, that all contractual arrangements and material authorizations necessary for the construction, operation and debt service of the project are legally binding and enforceable. There may be several classes of lending banks (project lenders), e.g. international banks lending foreign currency; local banks lending domestic currency for local costs; national export credit agencies lending or guaranteeing credits to finance suppliers of domestic equipment to the project; international agencies lending or guaranteeing development credits (World Bank, Asian Development Bank, African Development Bank, European Bank for Reconstruction and Development). For ensuring their common interests as to debt repayment, there is frequently an intercreditor agreement between the project lenders.

5) After completion of the project, the debt is repaid to the banks out of the sale's proceeds of the project's product, gained during the operational period of the project. The debt repayment period may yield even five to thirty.

1.3. Project loan agreements and the choice of law and forum

The parties to an international project financing can choose the law governing at least the major part of their contractual relationship. The focus in this thesis being on the contractual risk minimization techniques available to the project lenders, the following discussion is intended to highlight the main considerations for the choice of law and the forum from the project lenders' perspective. The traditional rule in international financing is that private lenders prefer their loan agreements to be governed by their own law or some other "external law", i.e. a law other than that of the borrower's country. This approach, however, is not always applicable in project financing.  

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Private lenders often choose their loan agreements to be governed by the laws of New York and England, which in many cases are also the law of the lender's home country. The reason for choosing an external law is often threefold. Firstly, the choice of an external law may be intended to offer insulation against adverse changes in the legislation of the borrower's home country (protection against legislative or political risk). Secondly, an external law with sufficiently developed case law and legal praxis may provide predictability concerning the outcome of the possible litigation. Thirdly, the choice of a law unrelated to the parties may serve as a compromise solution. However, taking into consideration the lender's interests, there are aspects which may make it beneficial to link the governing law of the loan agreement with the enforcing forum.

As to the choice of forum, a lender seeking to protect his interests should examine the enforceability of a judgment given by the forum. Since the judgment is useless if it cannot be effectively enforced, lenders should seek a forum in a jurisdiction where the borrower has assets, or attempt to find a forum whose judgment is enforceable in that jurisdiction.

In project financing, the borrower typically is a project company, incorporated in the project's host country in which the assets necessary for the operation of the project - mainly consisting of real property, facilities, equipment and inventory owned by the project company - are located. As to these assets, the only efficient enforcement mechanism available for the project lender might be to bring a suit in a forum of the project's host country. Consequently, as regards the choice of law applicable to the project loan agreement and related security agreements, there are conveniences in choosing the law of the project's host country whose courts are most likely to be called upon to enforce the agreements (law of enforcing forum). The law of the place of incorporation of the borrowing project company governs its capacity to enter into contracts, its organization, its liquidation and, subject to various exceptions, its insolvency and bankruptcy proceedings. Security interests,

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10 Mettälä, 242 and 243.
11 *Id.* 237.
12 *Id.* 242.
14 Harries, 352 and 353.
like mortgages and charges over the borrowing project company's real property, facilities and inventory, must be established under the local law (lex rei sitae). The local law also provides the legal framework for enforcing the security interest. In addition, the inherent difficulties and costs involved in proving the contents of foreign law, applicable to the project loan agreement, may be arguments leading the project lenders to consider the choice of the law of the enforcing forum as the governing law of the project loan agreement. Finally, there may be instances where either public policy or mandatory rules of the enforcing forum may lead to application of local law, regardless of a choice of other governing law in the project loan agreement.

As a conclusion, when considering the choice of the governing law of the project loan agreement, the choice should go, in the first place, to the law which is most suitable for enforcement of the project loan agreement in court or in a bankruptcy proceeding of the project company. Therefore, the law of the project's host country, i.e. the law of the place of incorporation of the project company and the place of location of major tangible assets, should be considered first.

1.4. Aims, scope, limitations and structure of the study

The purpose of this study is to describe the main characteristics of international project financing, to identify the contractually-manageable factors determining the riskiness of the project lender's claim on a project company, and to examine the functions of the project lender's contractual risk minimization techniques.

15 Mettälä, 242.
16 Id.
17 Harries, 352.
18 This study is also meant for serving as an introduction to the comprehensive analysis of legal transaction related objectives and means in creditor's overall credit risk minimization process. The present study is drawn up in connection with the author's licentiate thesis “The Legal Transaction Related Objectives and Means of Credit Risk Minimization in Project Financing and Cash Flow-Based Credit Financing ”, in which the risks and conflicts determining the credit risk and the functions of various legal means for managing them are more thoroughly dealt with. The research mentioned above is one part of the research project of the Academy of Finland, “Modernization of Property Law in the Finnish Society after the Bank Crisis ”. In Finland, the importance of secured credit financing (asset-based financing) has been traditionally strong. However, in many fields the business activities of Finnish companies tend
The essence of project financing is mainly a clear, complete and realistic analysis of the risks of a particular project, combined with an effort to manage the identified risks by transferring, allocating, and sharing the risks among the various parties. The risk management may appear to be primarily a financial phenomenon. However, it can be argued that it is essentially a legal phenomenon, since the level of risk bearing of the project's participants is dependent on the underlying contractual network of the project, in which the project risks are distributed by establishing risk-related rights and obligations among the project's participants.

Legal documents of international project financing arrangements are prepared on a case-by-case basis and drafted to meet the requirements of the particular project in question. Each individual project has its own characteristics and involves a unique set of risks and conflicting interests among the parties. Accordingly, there are no standard structures or forms, no standard contracts, no general rules or conditions for project financing. Moreover, there are no uniform laws for international project financing.

However, there are some basic concepts, basic legal instruments and clauses which are frequently used and characteristic in project financing arrangements. In this study, the focus is on legal risk minimizing instruments and arrangements, which may be used for project lenders’ protection in almost all cash-producing projects, whatever their nature may be. The legal arrangements examined in thesis are assumed to be made between private parties.

to be increasingly based on the exploitation of well educated labour force, innovations, intellectual property rights and high technology. Therefore, the market value of the companies' movable or immovable assets less frequently forms a solid base for secured financing of investments. As a result, the credit financing of Finnish companies is transforming to be increasingly "cash flow-oriented", i.e. the credit financing transactions are principally based on the predicted cash flows of the borrowing companies. As the security interests to companies' movable or immovable objects are gradually loosing their traditional role as legal means of minimizing credit risks, the importance of other types of legal means is gradually increasing. The principles of the comprehensive approach for the use of various legal credit risk minimization techniques laid down in this study are generally applicable to the cash flow-based credit financing.

19 Harries, 350.

20 Rauner, 156.

21 See Harries, 350.
The initiators of project financing arrangements are the project sponsors. In this study it is assumed that project sponsors want to implement the project through a sole purpose limited liability company or a company limited by shares (herein referred to as a project company) the incorporation or establishment of which is subject to the company law of the project's host country, _i.e._ the country in which the project is located and carried out. Moreover, the project company is assumed to be the borrower, and the project loan is assumed to be made in the form of a term loan agreement. From this basis it is possible to identify four essential _areas of legal relationships between private parties_ which are of special importance for project lenders:

a) relations between the project company, the project company's shareholders or sponsors and the commercial project lenders, determined by the legal instruments of actual financing arrangements, _i.e._ a project loan agreement, security agreements and guarantee documents;

b) relations between the project company and the buyers of its end-product, determined ideally by long-term sales agreements;

c) relations between the project company and its energy and/or raw-material suppliers, determined by the supply agreements; and

d) relations between the project lenders, determined by the inter-creditor agreements.

The legal relationships of a project related to the governmental authorities of a project's host country or other public entities are excluded from the scope of this thesis.

_The purpose of this study is to describe the characteristics of international project financing and to examine the project lenders' contractual risk minimizing techniques which can be used within the fields of contractual relationships as mentioned above._ In these relationships the contracting parties agree to transfer or share certain project risks by establishing rights and obligations which, directly or indirectly, to a certain extent ensure the debt repayment of the borrowing project company. Moreover, in a debtor-creditor relationship between a project company and a project lender, property rights are created by establishing security interests on project assets. Accordingly, the focus on legal issues is mainly related to the law of obligation and the law of

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22 The list of the relationships is based on the division of main legal fields in project financing in Harries, 350.
property. In order to keep this study within reasonable bounds, the legal issues essentially related to other fields of law are just mentioned or dealt with very briefly.

After the disbursement of the project loan amounts, the relationship between the project lender(s) and the borrowing project company is characterized by the project company's obligation to repay the principal, the interest and the possible fees. Accordingly, the main objective of the project loan agreement, and the related contractual network of a project financing arrangement, is to ensure that those amounts are paid to the project lender(s) regardless of the risks which may materialize.

As a basis for examining the functions of the various contractual risk minimization techniques of project lenders, the aim of this thesis is to identify the contractually manageable factors determining the riskiness of the project lenders' claim on the project company. For the purposes of this study, the main factors are identified as 1) the project lender's recourse to third parties, 2) the project lender's priority right to project assets, 3) the project lender's right to decide about the acceleration of the project loan, 4) the project lender's right to supervise and control the operations of the borrowing project company and the project assets, and 5) the co-operation among the project lenders and other creditors in using their remedies against the borrowing project company. These factors form the conceptual framework within which contractual means, ensuring the repayment of the project loan, can be categorized and examined, and within which their functions can be analyzed. This kind of approach should help to locate, to analyze and to compare the legal instruments according to their purpose and objective in the context of a project lender's overall credit risk minimization. It should also make it possible to view some aspects of the weight and interplay of each category as parts of the whole.

The materialization of project risks jeopardizes the ability of a project company to repay the project loans and may cause the insolvency of the project company. In the case of a project company's insolvency there are certain obvious reaction alternatives for project lender(s), depending on the present financial situation of the project company and the legal instruments which are used in project financing arrangement for lenders' protection. The conceivable reaction alternatives include:

1) re-scheduling and re-structuring of the project loans;
2) supporting the project company with additional loans, in order to make its operation capable of generating sufficient cash flow for debt repayment;
3) recourse to third parties under the guarantees and other debt repayment securing obligations;
4) liquidation of the project company, and the realization of project assets by enforcement; and
5) take-over of a project for the purpose of subsequently selling it as a going concern.

Being oversimplified and overlapping, the above mentioned list of possible reaction alternatives of project lenders is not exhaustive. However, it is in these situations, following the choice of the reaction alternatives, in which the rationality and effectiveness of the contractual risk minimization arrangements for the lender's protection are tested. Accordingly, the aim of this study is also to observe the functions of contractual risk minimization arrangements of project financing in the light of a project lender's reaction alternatives in a project company's insolvency.

In this study, chapter 2 traces the origins of project financing and serves as an introduction to the basic concepts of limited recourse, non-recourse and limited liability in the context of project financing. In chapter 3, the definition of project financing is dealt with as it is established in the meaning of a specialized field of international commercial banking. Chapter 4 deals with the sponsoring companies' economic incentives and legal reasons for seeking project financing. Incentives from the project lenders' point of view are also viewed. Chapter 5 describes the phases of the implementation of a project, the main categories of project risks, and the basic principles of risk management and contractually manageable factors determining the project lenders' credit risk as a basis for the next chapters. The various types of debt repayment securing third party undertakings, with special regard to their functions as risk-transferring and risk-allocating devices, are discussed in chapter 6. Chapter 7 deals with project lenders' priority right to project assets and examines the meaning of security arrangements in project financing. Chapter 8 is dedicated to examining the issues related to the acceleration of a project loan. Various types of covenants in project loan agreements, for the purpose of controlling and restricting the transactions and operations of the borrowing project company, are dealt with in chapter 9. In chapter 10 the focus is on the inter-creditor agreements which lay the principles for co-operation between the project lenders. Finally, in chapter 11, some conclusions are drawn as to the role of contracts in project financing arrangements and the meaning of achieving various credit risk minimization objectives.
2. THE ORIGINS OF PROJECT FINANCING

The term "project financing" may be relatively new, but the financing method itself is probably as old as commercial lending activities. Wherever big amounts of capital and high risks have been involved in a specific business project, the parties involved have been looking for a way to limit and share their risks. The economic and legal environment in which the sponsors and lenders of projects operate have naturally changed over the years, but the fundamental objectives and problems have remained the same.

It can be argued that the history of project financing is in essence the same as the history of a limited or non-recourse concept. The concept of a lender looking principally to the proceeds, or to the cash flow generated by a specific project to pay the debt, was recognized as early as in the commercial code of classical Athens. *The Greek bottomry loan (nautikon danaion)* was only repayable from the proceeds of the sale of a cargo. If the ship carrying cargo was lost at sea, the loan was not repayable.\(^23\) Accordingly, the Greek bottomry loan was made on a non-recourse basis, *i.e.* the lender had no recourse to the assets of the borrower, except to the cargo. The Greek bottomry loan was essentially based on the idea of surrogation. The lender was entitled to whatever was bought with the money he had lent to the borrower. Thus, the merchandise was regarded to be pledged to him. If the goods were lost during the sea journey, the lender had lost the object which the liability of the borrower was attached to. As a consequence, his claim for repayment also fell away.\(^24\)

The idea of the Greek bottomry loan was later adopted in Roman law in the form of *fenus nauticum* (sea loan). In classical times, the Greek custom served as a kind of common law for all the Mediterranean nations involved in overseas trade. Roman practise, too, followed it very closely.\(^25\) Like the Greek *nautikon danaion*, the Roman *fenus nauticum* was a loan of money given to a merchant involved in overseas trade and lacking the capital to buy the merchandise and ship it solely at his own risk. Usually, the loan was given for the round-trip voyage. At the port of departure, the merchant would use the

\(^{23}\) McKechnie, 270.


\(^{25}\) *Id.* 183.
money to buy articles suitable for export. He would then use the export proceeds to purchase import articles.\textsuperscript{26}

Sea voyages on the Mediterranean were dangerous in Greek and Roman times, involving high risks because of storms and pirates. The Greek \textit{nautikon danaion} and the Roman \textit{fenus nauticum} can be seen as early examples of a lender expressly assuming project risks, \textit{i.e.} the capital was given by a lender to be used to carry out a certain project, not only being at the risk of the borrower, but also at the risk of the lender. Thus, there \textit{was an element of equity risk} in these financings. Since the loan of money had to be repaid only if the ship arrived safely in port with the cargo on board, the lender, too, \textit{took part in bearing the risk of a project failure}.\textsuperscript{27} These financings also involved a certain \textit{element of marine insurance}, which the merchants of those days were looking for. If the risks were materialized and the ship carrying the cargo was lost at sea, the loss of the amount of the loan was born by the lender. Because of the high risk the lender had to bear, high interest rates were charged as premiums from the borrowing merchants.\textsuperscript{28} In order to ensure their returns, the lenders, of course, had to spread their risk by diversifying their loan portfolio and claims to a number of borrowing merchants conducting overseas trade. In this respect, one could say that there is nothing new under the sun.

During the following centuries, more applications for using a limited recourse concept (or a limited liability concept from the borrower's perspective) and a project financing approach were developed to finance business activities involving high risks. In the Middle Ages and early colonial times, overseas investments, trade and ship building were largely supported by financing involving project risk.\textsuperscript{29} In the period of expansion of trade and industry in the nineteenth century, one of the key ideas involved in the development of business entities was the creation of a \textit{limited liability company}.\textsuperscript{30} Among the most important underlying incentives for the creation of the limited liability company form was the social objective of encouraging

\textsuperscript{26} Id. 182.

\textsuperscript{27} Id. 182; Taco Th van der Mast and JP Morgan, \textit{Ship Finance}, in Project Lending 37 (TH Donaldson ed. 1992).

\textsuperscript{28} Zimmermann, 182.

\textsuperscript{29} Harries, 347.

\textsuperscript{30} McKechnie, 270.
risky business investments by preventing the shareholders of a company from suffering a loss exceeding their investment in the company. The basic premise of the limited liability company was (and still is) the limitation of recourse: a creditor to a limited liability company could not proceed against the assets of its shareholders in order to recover his claim, unless the shareholder had entered into a contract or a guarantee in effect permitting him to do so. As a matter of fact, number of loans without substantial shareholder guarantees (or other third party guarantees) which, over the years, have been made to single limited liability project companies, have been de facto project financings, whether or not they have been seen as such by the bankers involved. As regards limiting of the project lender's recourse to a specific project, the establishment of a limited liability company charged with the construction and operation of the project, and being liable for repayment of the project debt, has generally remained the most satisfactory means of fulfilling this purpose.

32 McKechnie, 270
33 Id.
3. DEFINITIONS AND CHARACTERISTICS OF PROJECT FINANCING

3.1. Definitions

One of the most "official" definition of project financing has been given in the US by the Financial Accounting Standards Board (FASB), for accounting purposes. It reads as follows:

"(Statement of Financial Accounting Standards No. 47: Disclosure of long term obligations. March 1981). Project financing arrangement. The financing of a major capital project in which the lender looks principally to the cash flows and earnings of the project as the source of funds for repayment and to the assets of the project as collateral for the loan. The general credit of the project is usually not a significant factor, either because the entity is a corporation without other assets or because the financing is without direct recourse to the owner(s) of the entity.

The Export-Import Bank of the United States has adopted, from its own point of view, a somewhat different wording in defining project financing:

"The term 'Project Finance' refers to the financing of projects that are dependent on the project cash flows for repayment as defined by the contractual relationships within each project. These projects do not rely on the typical export credit agency security package which has recourse to a foreign government, financial institution or established corporation to meet a reasonable assurance of repayment criteria. By their very nature, projects rely for successful completion on a large number of integrated contractual arrangements."

In his book Project Finance Graham D. Vinter, focusing on legal issues of project financing, prefers the following definition:

"... project finance is financing the development or exploitation of a right, natural recourse or other asset where the bulk of the financing is not to be provided by any form of share capital and is to be of revenues produced by the project in question".35

These examples show that although there is no strict definition of "project financing", the concept itself is well established. The essence of project


financing is its focus on the project which is being financed. The lender looks, wholly or mainly, to the project as the source of repayment; its cash flows and assets, where appropriate, are dedicated to service the project loan.

3.2. Categories - dependence on project and its cash flow

To illustrate the nature of project financing, categories can be made according to the dependence of the debt repayment on the success or failure of the project in generating sufficient cash flow. In the following discussion, it is assumed that the borrower is a newly established project company without credit history.

In pure project financing the project loan is the sole source of credit finance for the project, and is repaid only from the cash flows and the assets of the project company. As to the debt repayment, pure project financing is equivalent to the concept of non-recourse financing. Completely non-recourse financings, however, in which the lenders look exclusively to the cash flow and the assets of the project, and in which they have no other form of external credit support for the debt repayment, are relatively rare.

The more typical project financing falls in the category of partial (or qualified) project financing. Like in pure project financing, the lender’s risk here remains to a great extent in the project, but the repayment of the loan no longer depends solely on the project's assets and cash flows. Partial project financing is equivalent to the concept of limited recourse financing. Here, the lenders have the benefit of some form of support from outside the project. In other words, the project lenders have direct or undirect recourse - predefined and limited in the financing documents - to the project's sponsor(s) and/or other third parties interested in the project in question. The outside credit support may take several forms of guarantees and support agreements, the legal nature and characteristics of which are discussed later.

The two categories of project financing mentioned above involve a project risk from the lender's point of view, i.e. the debt repayment is solely or largely

37 McKechnie, 269; See also Richard A. Brealey and Stewart C. Mayers, Principles of Corporate Finance, 696 (5th ed. 1996).
38 TH Donaldson and J P Morgan, 5.
39 McKechnie, 269-270.
dependent on the success or failure of the specific project in generating sufficient cash flow. From the borrowers' point of view, a "conventional" corporate borrowing may also involve an element of project risk in situations, where a corporate borrower raises loans in its own name to fund a major project. Where the borrower's financial position is strong enough to bear the complete failure of the project without any significant weakening, this is not a project risk for the lenders, although it may be such for the borrower. The failure of the project can seriously weaken the borrower, although not, alone, destroy it. In this case, if there is any chance of project failure, the lenders' credit risk analysis and the conditions on which they lend may become more project orientated.\footnote{TH Donaldson and JP Morgan 6.}

In order to further describe the nature and the characteristics of project financing, comparisons can be made between project financing and \textit{limited recourse asset-based financing},\footnote{Asset-based financing or secured lending is the institution whereby a creditor can establish a right over the property of a debtor to secure the satisfaction of a debt or performance of an obligation. In case of default, the creditor can take redress against the specified property and is entitled to receive proceeds from its sale. See e.g. William Arthur Rich, \textit{A Survey of Asset-Based Lending in Central and Eastern Europe}, 28 Butterworths Journal of International Banking and Financial Law, Special Supplement, September 1995.} as regards the value of the assets used by way of security. In limited recourse asset-based financing loans for the purpose of, for example, acquiring and redeveloping a property, may be agreed and structured so that the lender has no right to recourse from the borrower, except only to the extent of the proceeds of sale of the property in question and to the extent of the income derived from it. Such a loan would be secured by a mortgage over the property, and the rents to be paid under the leases would be assigned to lenders by way of security.\footnote{Clifford Chance, Project Finance, 4 (1991).} Here, the value of the property used as security may, to a great extent, cover the amount of the loan. Similarly, typical for project financing is that there is mortgage over the project's physical assets and that the rights to the cash flow from the project are assigned for the benefit of the lenders. In project financing, however, the value of the physical assets comprising the project are typically substantially lower than the loan amounts advanced.\footnote{Id.} Thus, the enforcement of security would offer a far from
fully satisfactory resort for project lenders. Therefore, in project financing, unlike in limited recourse asset-based financing, the project's economic viability is crucial and there is a need to decide how the risks associated with the project are to be allocated between the lenders and the other parties of the project financing arrangement.44

3.3. Limiting of lenders' recourse

From the sponsors' point of view, the ultimate goal in project financing is to arrange for a project debt financing which benefits the sponsor, and at the same time is completely non-recourse to the sponsor, in no way affecting its credit standing and balance sheet.45 However, as mentioned before, projects rarely are financed independently, on their own merits, without limited outside credit support from sponsors. Project financings typically fall into the category of limited recourse financing.

Project sponsors seek to limit their own risk by limiting, as far as possible, the project lender's recourse against them. There are basically two ways to limit a lender's recourse to a project. Firstly, the recourse against the project sponsors, if the project is owned directly by them, can be limited by contract, i.e. by provisions in the credit agreement governing the financing of a project which remains part of a larger corporation.46 Under this limited recourse loan contract, the project lenders agree to look only to the specified assets and the cash flow on which they have security as resort for debt repayment. In addition, the project lenders exclude their rights to sue or to liquidate the sponsor, to levy execution over non-project assets, or to prove in the sponsor's liquidation.47 Contractual limitation, however, may prove difficult to draft in the financing documents, technically unsatisfactory, and in practice uneffective in isolating the sponsor company's liability and risk.48

44 Id.
46 McKechnie, 272.
47 See Wood, Project Finance, Subordinated Debt and State Loans, 23.
48 McKechnie, 272.
The other way of limiting recourse is to segrate the project into a special purpose vehicle company, and use it as a borrowing entity.\textsuperscript{49} If the project and its assets are transferred and segregated from the project sponsor’s ownership into a legally separate borrowing entity, and if this borrowing entity is a company of which partners or shareholders are not personally responsible for the liabilities of the company (\textit{e.g.} a limited liability company or a company limited by shares), the debt repayment is the borrowing company’s, not the project sponsors’ (shareholders’) obligation.\textsuperscript{50} Any guarantees given by the project sponsors will, of course, override this limitation of the sponsors’ liability. Normally, project sponsors are required to provide some sort of limited credit support to project lenders (limited recourse finance).

In many countries, the establishment of a local project company for operating a project is required by the foreign investment laws or host governments. For this reason, only a project financing structure involving a local project company as a borrower is examined in this study.

\textsuperscript{49} \textit{Id.}

\textsuperscript{50} Clifford Chance, 20.
4. REASONS AND INCENTIVES FOR PROJECT FINANCING

4.1. Sponsors' economic reasons

The initiators in project financing arrangements are the sponsors of the project, who need debt financing for the implementation of a specific project. A sponsor might be one company, or a consortium of interested parties like contractors, suppliers, and/or purchasers of the project's production, of its goods or its services.\(^5^1\) The motivation of a project sponsor to implement the project may be to make a profit by selling the product produced by the project, or to provide processing or distribution of a basic product of the sponsor himself, or to ensure a source of supply, vital to the sponsor's own business.\(^5^2\) The sponsors investing equity capital for the project can be called owners of the project.

Project financing, for various reasons, is more expensive than conventional corporate financing. Firstly, the lenders, their technical experts and the lawyers have to spend a lot of time in evaluating the project and negotiating the complex project documentation. Secondly, monitoring of the technical progress and performance of a project and policing the loan during the life of the project, is costly. Thirdly, the charges made by the project lenders for assuming additional risks are high.\(^5^3\) The advantages of project financing to the project sponsors must, therefore, be substantial to compensate for these additional costs.

Nevertheless, from a sponsoring company's point of view, there are various economically beneficial reasons for project financing. Firstly, project financing is often the only option where debt financing is needed to finance a major investment project. In many cases, there is no alternative between project financing and conventional corporate debt, the sponsor company having insufficient non-project assets and cash flow on which its financing could be based.\(^5^4\) (In these situations, even though the entire sponsor company would be liable for debt repayment with all its assets and cash flow, the loan for

\(^{5^1}\) Id. 9.


\(^{5^3}\) Clifford Chance, 5.

\(^{5^4}\) McKechnie, 274.
financing a project is *de facto* project financing and should be assessed as such by the lenders). In cases where project sponsors, in principle, could choose between project financing and conventional corporate borrowing, the first and most powerful motive for borrowing on limited recourse terms is the desire to *limit their risk* to the amount of equity invested and to *share risks* of the project with project lenders.\(^{55}\) For example, if a project sponsor initiates a project, the total investment cost of which is five hundred million dollars, it may be able and willing to invest one hundred million dollars as equity in such a project. The sponsor company, however, may not be willing to invest additional equity in the project or to borrow additional money in his own name in order to finance the project. This is because, if the project fails, such exposure could lead to the bankruptcy of the sponsor company. Thus, the sponsor will seek financing from banks willing to take on project risks. In other words, in project financing "a sponsor will risk a loss of his investment, or even risk a loss before the lenders to the project suffer a loss, but it will not risk its own corporate existence."\(^{56}\)

The second inherent incentive for project financing is *the leverage effect*, i.e. a smaller percentage of equity in relation to the total investment may allow higher dividends and a quicker return on the equity investment for a project sponsor.\(^{57}\) Project companies' debt/equity ratio may be very high. Of course, the amount of debt financing varies from project to project. Typically, for a private project, the need for project lending is to cover approximately forty to fifty percent of the total project cost.\(^{58}\) In some projects the amount of debt capital is extremely high. For example, in energy projects it can be even ninety percent.\(^{59}\)

The third important incentive of the project sponsors for seeking project financing is the concept of *off-balance sheet financing*.\(^{60}\) Here, the project sponsors aim to avoid the appearance of dept repayment obligations on their

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\(^{55}\) McKechnie, 273; Harries, 347.

\(^{56}\) Harries, 347.

\(^{57}\) *Id*.

\(^{58}\) Rauner, 157.


\(^{60}\) Harries, 348.
balance sheets, which would adversely affect to their credit rating and, consequently, possibly increase the interest rate of their future borrowings. If the sponsor companies establish an independent project company, charged with the construction and operation of a project, and will use this company as a borrowing entity, the loans made for financing the project do not, in principle, depending on the national accounting law and practice applicable to the sponsor companies, appear significantly (if at all) on their balance sheets.

While the project lenders frequently require some form of limited guarantees for securing the debt repayment of a project company, the sponsor companies may try to avoid the appearance of direct payment guarantees on their balance sheets by using alternative forms of debt repayment obligations. This, of course, can be done only in close collaboration with the project lenders. The necessary credit support can be given, for example, under a take-or-pay contract, in which the sponsor company obliges itself to buy the project company's whole production or a certain portion of it. Here, the sponsor company is obliged to pay a fixed price periodically, whether the products actually are supplied or not. The proceeds under the take-or-pay contract can be assigned to the project lenders, thus assuring the debt service. Whether the project sponsor's obligation under the take-or-pay contract is required to be disclosed in the sponsor's balance sheet, depends on the national accounting law and practice of the sponsor's home country. Although the accounting treatment differs from country to country, it is likely that, by virtue of developing accounting practices, fewer disguised forms of credit support given by project sponsors can escape the balance sheet treatment. Where the accounting treatment, however, "follows the form rather than the substance", off-balance sheet considerations remain highly relevant.

61 See A.D.F. Price, 45.
63 Harries, 348.
4.2. Sponsors' legal reasons

In addition to the economic reasons and incentives discussed above, there may also be some legal factors that can affect a project sponsor's choice between project financing and conventional corporate borrowing in its own name. The sponsor company's constitutional or corporate documents, e.g. articles of association, statutes and by-laws etc., may contain provisions where the power of the sponsor company or its directors to raise money by borrowing and/or to give guarantees, may be limited to a determined amount. Restrictions on conventional borrowing may also be included in the sponsor company's existing loan agreements. Limitations may exist, especially in unsecured loans where, instead of taking security, the lenders may be willing to rely on financial covenants of a loan agreement, which require the borrower to keep to certain debt/equity ratios or other formulae.\textsuperscript{65} Depending on the actual wording of the restrictions, they sometimes might be avoided by using a wholly or partially owned special purpose project company as a borrowing entity.

As to the restrictions on giving guarantees in corporate documents or existing loan agreements, a sponsor company may be able, depending again on the wording of the restriction in question, to support the financing of a project by entering into e.g. a take-or-pay contract instead of giving a straightforward guarantee to project lenders. Under a take-or-pay contract, the sponsor company is obliged to pay, periodically, fixed prices for the project's end-product, in order to ensure a sufficient cash flow for the debt service of a project company. This kind of obligation may escape falling within the scope of guarantee restrictions.\textsuperscript{66} As already previously discussed, the use of a take-or-pay contract may also involve the benefit of an off-balance sheet treatment.

4.3. Lenders' incentives

From the commercial banks' point of view, the financing of projects may offer attractive financing opportunities. Willingness to assume higher risks inherent to project financing can be compensated by higher margins of profit. Compared to conventional corporate financing, the project financing approach may be beneficial by offering recourse limited to a particular project, but being secured

\textsuperscript{65} Id. Financial covenants are discussed more closely in Chapter 9 below.

\textsuperscript{66} Wood, Law and Practice of International Financing, 316.
on the project’s assets and the proceeds from the sale of its product. This benefits the lenders, who thereby are protected from the claims of sponsor company’s creditors; *i.e.* the sponsor company’s own creditors have no competing claims against the assets of a project company.\(^6^7\)

5. PROJECT IMPLEMENTATION AND PROJECT RISKS

5.1. Project phases

Generally, the implementation of a project contains three phases. Focusing on the time dimension and on the project risks, these phases can be seen as distinct risk periods from the project lenders' perspective. When analyzing the risks, the project planners distinguish between the construction phase and the operational phase of the project.68

1) In the preparation or planning phase, the feasibility and the engineering studies of the project are undertaken and completed. Moreover, the project contracts between the parties interested in the project are negotiated. The costs of this phase are normally financed by the equity of the sponsors or by loans fully guaranteed by them.69 Thus, the planning phase does not usually involve major risks for project lenders.

2) In the construction or pre-completion phase, the project loan will be disbursed and the construction of the project will begin. The construction phase covers the project before it is complete and able to produce its end product. In this phase, the project is absorbing finances, but does not generate any income. The lenders will usually allow a grace period for repayment.70 The construction phase is the period of the highest risks for project lenders. Completion of a project will mark the end of the construction phase and the beginning of the operational phase.71

3) In the operational phase, the project begins to produce goods or services, and - provided that the cash flow projections prove correct – generates enough revenues to cover the operational costs, the debt service for the project lenders, and the dividends for the shareholders (sponsors) of the project company. During the operational period, the long-term project loans are gradually repaid. Short-term project loans, however, might still occasionally be needed as working capital.72

68 Rendell and Niehuss, 32.
69 Harries, 348.
70 Clifford Chance, 20; Harries, 348.
71 Clifford Chance, 20.
72 Harries, 348.
5.2. Main categories of project risks

Since project financing is primarily based on a project's revenue and assets to provide the source of debt repayment, the project lenders are concerned about developments that would interrupt a project's revenue stream or reduce the value of the project assets. Only if the project generates a cash flow sufficient to cover the operating costs and the debt service, the lender can expect to recoup the amounts lent and to gain adequate compensation for the credit risk it has assumed. Hence, the project lenders assume the same project risks as the equity investors (owners, shareholders) of the project, although this happens on a better risk level, because of their priority right to project assets as creditors. Another issue, however, is that the project lenders frequently do not accept all the project risks to be carried on their own, but require contractual obligations to carry certain risks of other parties to the project.

Next, the principal categories of project risks are introduced. Here it should be mentioned that there may be many approaches in categorizing the project risks. The following categories are made in order to present a general description of the causes and effects of the project risks.

Completion risk. The most extreme form of pre-completion risk is the possibility that the construction of the project is never completed. As a result, the project never generates any revenue, and the project company is unable to repay its debts to the project lenders. Less extreme forms of pre-completion risks are delays which threaten the viability of the project, or cost overruns which can be caused partly by delays. The materialization of these risks increase the need for finance to complete the project, making it less likely that the future revenues of the project company can service the debt in full.

Operational risk. The precise form of operational risk depends on the nature of the project. As to operational risk, the question is, in short, whether or not the project can successfully produce its end-product (goods or services). The operational phase risks may include e.g. inadequacy of power, water or

73 Rendell and Niehuss, 32.
74 See e.g. Teolis, 197.
75 TH Donaldson, 6.
76 Id.
77 Id.
raw material supply, continued unavailability of qualified managerial personnel, or technical difficulties.\textsuperscript{78} As a result, the project probably may never produce as much, or as high a quality, as expected, or it costs more to run.\textsuperscript{79}

\textit{Market risk.} Like operational risk, the market risk may be materialized after the project is completed and its operation commenced. The market risk covers both supplies to the project and sales by the project. The supply risk is crucial where a project is dependent on its ability to purchase raw materials and/or energy at a certain price, in order to produce its product at sufficiently low costs. The other critical question is whether the project company can sell its production at a competitive price, covering both operational costs and debt service. The price fluctuations of both supply and sales markets can adversely affect the debt repayment ability of the project company.\textsuperscript{80}

\textit{Political and regulatory risk.} The major political risks endangering the project are expropriation of the project by the project's host country, governmental interference with the project's operations (ranging from excessive or unreasonable changes in laws relating to taxation, import duties, labor, local supply, nationalization of the project company's management, or environmental protection), war or civil disturbance threatening the construction or operation of the project, and blockage of foreign currency remittance (\textit{i.e.} the risk that the funds earned by the project cannot be converted into currency required for the debt service and transferred outside the project's host country).\textsuperscript{81} As the focus in this thesis is on the legal relationships between the private parties of a project, the examining of risk management of political risks is excluded from the scope of this study.

The categories mentioned above are not meant to be an exhaustive list of project risks. The discussion of the risks is intended to serve as a basis for examining those contractual arrangements by which completion risk, operational risk and market risk affecting the project lenders' overall credit risk can be managed.

\textsuperscript{78} TH Donaldson, 7; Rendell and Niehuss, 32.

\textsuperscript{79} \textit{Id.}

\textsuperscript{80} Wood, Project Finance, Subordinated Debt and State Loans, 6; Harries, 349.

\textsuperscript{81} Rendell and Niehuss, 32; Harries, 349.
Managing of project risks involves, as any risk management process, three main elements. These elements are:

1) identification of risks,
2) evaluation of risks, *i.e.* estimation of the likelihood of an identified risk being materialized, and the estimation of its effects, and
3) choosing of the most efficient and cost-effective risk minimization method.  

As to *choosing the risk minimization method*, there are three general ways to minimize the combinations of risks to be borne by each of the private parties involved in a project and its financing. Firstly, measures should be taken to reduce the overall risk confronting sponsors and lenders to the lowest possible level. *Risk reduction* seeks to minimize the probability of occurrence of various contingencies which may adversely affect a project. In case of commercial risks, there is little the parties of a project can do to prevent the contingencies stemming from general business cycles or macroeconomic trends. The commercial risks arising solely from activities connected with a specific project can be controlled by project lenders, mainly through the exercise of careful business judgment and a variety of safeguard techniques, *e.g.* the hiring of independent experts to check the project design, careful selection of contractors, and checking out the credit standing of contractors.  

Secondly, the remaining risk should be allocated among the parties of the project in a mutually acceptable way. *The allocation of risks* is carried out in negotiations concerning project contracts (*e.g.* construction contract, equipment supply contract, raw material or energy supply contract, or the purchase contract of a project’s product) and financing agreements. Negotiations on risk allocation are principally motivated by the following three factors: 1) the need to meet the standards for financeability of a project, 2) the objective that all significant risks should be allocated to the parties which are best able and most motivated to handle them, and 3) the need to be ensured that the residual risks

83 Rauner, 161-162.
84 Id. 161 and 165 et seq.
are reduced to a level that the sponsors and lenders can effectively manage.\textsuperscript{85} Finally, each party may individually choose to reduce both its potential profit and the allocated risk by taking insurance. The use of insurance transfers risks and protects the party in question, but at the same time the insurance costs decrease the profit which the party expects to receive from a project.\textsuperscript{86}

It should be noted that although the methods of risk reduction, risk allocation, and further risk spreading by insurance are analytically distinct, they are closely related and often overlapping in practice. For example, the ability of each party to insure is a major factor in determining the outcome of the risk-allocation process.\textsuperscript{87}

5.3. Contractually manageable factors determining the project lenders' credit risk

After the discussion about the methods of risk reduction, risk allocation and insurance involving all the participants of a project, the focus in the following is on the risk minimization mainly from the lenders' point of view. When sponsors and project lenders employ the techniques of project financing in the typical form, they establish a separate legal entity (often a limited liability company or a company limited by shares) to construct and operate the project. The new project company is primarily financed through a combination of equity contributions from the sponsors and project loans from the banks.\textsuperscript{88}

Sponsors and project lenders have different types of claims against the project company. As shareholders, the project sponsors can expect a return on their investment in the form of dividends, and they have a right to the project company's assets in liquidation only after the claims of the project company's creditors have been satisfied. As creditors, the project lenders expect return on their investment in the form of interest under the loan agreement. Unlike the shareholders' claims, their claims are fixed to the amount of the loan, and they have a priority right to the project company's assets in liquidation. For this


\textsuperscript{86} Rauner, 179.

\textsuperscript{87} \textit{Id.} 161.

\textsuperscript{88} See e.g. Harries, 347; Rauner, 165-166.
reason, their investment generally involves less risk than the equity investment of the project sponsors.\(^{89}\)

There are methods by which creditors generally can protect their returns. Firstly, the creditors can adjust their return to reflect the involved risk by determining higher interest rates in loan agreements. As mentioned before, the higher risks lenders assume in project financing, compared to conventional corporate financing, are compensated by higher margins. The adjustment of the return to reflect the risk involved is frequently combined with the diversification of credit risk, i.e. creditors spreading their claims among a large number of debtors.\(^{90}\) Since international projects often are so large that no single project lender is willing to bear the risk of financing it alone, the project financing arrangements often involve a number of lenders. Finally, a factor generally affecting the riskiness of all the claims is the creditors’ possibility to deduct in taxation the potential credit losses.\(^{91}\)

In conventional corporate financing the lenders, in order to minimize their credit risk, concentrate on investigating the creditworthiness of a borrowing company. In project financing, however, the borrower is often a recently established company, charged with the construction and operation of a project, without operational history and assets on which the lending could be based on. Since the success of the project and the project company's debt repayment capability is dependent on the performances of a project's participants, the project lenders must carefully investigate the credit standing and operational history of the parties supporting and participating in the project, i.e. sponsors, contractors, equipment suppliers, energy and raw materials suppliers and purchasers of the project's end-product.

This study will now turn to a discussion on contractually manageable factors which determine the riskiness of a project lender's individual claim against a project company debtor. The first factor generally affecting the riskiness of a creditor's individual claim is the possibility of the creditor to have recourse to third parties, if the debtor cannot fulfil its debt repayment obligations.\(^{92}\) In project financing, the debt repayment securing obligations of

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\(^{89}\) As to shareholders' and creditors' claims against a company, see Rapakko, 222.

\(^{90}\) Rapakko, 224.

\(^{91}\) If the marginal tax rate, for example, approaches 50 percent, the deductibility in effect halves the risk assumed by the creditor, assuming that the creditor will have a taxable income in that tax bracket at the time the loan loss is realized. See Rapakko, 227-228.

\(^{92}\) See Rapakko, 227.
third parties may take several forms.

The second factor which the riskiness of a claim depends on is the priority right of the claim to a debtor's assets. The order of priority, in which the rights to corporate assets are satisfied, is determined by the underlying agreement concerning the claim and its security, by the security interest law, by the bankruptcy law and by the law on winding up of a corporation.  

Thirdly, the riskiness of a claim relates to a project lender's right to demand debt repayment under the project loan agreement. The act of a lender declaring the loans to be immediately due and payable is often called "acceleration". The riskiness of a claim is decreased if the creditor is entitled to accelerate the loan at his own discretion, when the economic strength of a project company debtor, for one reason or another, is becoming weaker, and the debt repayment is thus endangered.

In addition, the riskiness of creditors' claims is determined by the debtor's operations and actions with third parties. Thus, the credit risk may be reduced if the lenders can use contractual methods for supervising and controlling the debtor and its assets.

Finally, the riskiness of a single creditor's claim is dependent on the competing creditors' rights and acts towards the debtor. Thus, a creditor's risk may be reduced if the creditors can agree, for their common interest, about the optimal actions in using their remedies against the debtor. In project financing, therefore, project lenders often enter into an inter-creditor agreement.

The factors identified above, affecting the riskiness of a creditor's individual claim, are to a large extent contractually manageable. They form a conceptual framework of risk minimization objectives within which the legal instruments, used for project lenders' protection, are categorized and examined in the following chapters.

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93 Harries, 358; Rapakko, 226-227. It should be noted that the priority order of different types of claims may vary in national bankruptcy statutes.

94 Rapakko, 228.
6. PROJECT LENDERS’ RE COURSE TO THIRD PARTIES AND DEBT REPAYMENT SECURING THIRD PARTY UNDER-TAKINGS

A factor generally affecting the riskiness of a creditor’s individual claim is the possibility of the creditor to have recourse to third parties, if the debtor cannot fulfill its debt repayment obligations. In project financing, typically, an under-capitalized project company is set up to own and to operate a project having insufficient capital and revenues to support the borrowings on the merits of its own credit standing. Therefore, project lenders must be provided with satisfactory credit support from creditworthy third parties, in respect of a debtor-creditor relationship between a project company and a project lender.

The essential objective of a project financing arrangement is to combine various kinds of guarantees and undertakings from various interested parties of a project. The purpose is that the financial burden or risk of any party will not be too heavy. As a result, the combined guarantees and undertakings of all the parties will constitute a satisfactory credit for project company borrowing.  

One of the reasons to project financing is that it not only makes risk-shifting possible between the sponsoring shareholders of a project company and the lenders, but that it also makes it possible to allocate risks to other third parties, who are not equity investors (shareholders) in the project company. These third parties, willing to oblige themselves to support a project, frequently receive benefits from the project in one form or another, and this of course is the motivation for their undertaking. Private parties supporting the finance of a project by guarantees or other types of undertakings can be divided into following categories:

1) Shareholders of a project company. Possibly also having some of the roles listed below.
2) Contractors. Contractors operate in the construction business and are thus interested in building a project.

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95 Nevitt and Fabozzi, 255.
96 Id.
97 Nevitt and Fabozzi, 256.
3) Suppliers. Suppliers are interested in selling equipment, service, energy or raw material to a project.98

4) Buyers. Buyers are interested in buying the products and the services produced by a project.99

In project financing, the debt repayment securing obligations of third parties may take several forms. For the purposes of this thesis, a distinction is made between the direct and the indirect undertakings. Direct debt-repayment-securing undertakings constitute a payment obligation directly to project lenders. Indirect debt-repayment-securing undertakings, on the other hand, constitute a payment or other performance obligation to a project company for debt-servicing purposes. The promise to pay or perform may be given to the project company or to the project lender, or to both of them. The distinction of undertakings based on the aspect to whom the actual payment is directed, is seen here as reasonable. However, before the examination of guarantees and third party undertakings within the categories of direct and indirect debt-repayment-securing undertakings, two of them, comfort letters and completion guarantees, are discussed separately.

6.1. Comfort letter

A comfort letter is a document frequently found in project financing documentation. A comfort letter is usually given by the shareholder(s) of a project company or by some other interested party, in order to support the financing of the project company.100 Common letters may be used in circumstances where the shareholder of a project company or some other third party sponsor is unwilling to assume a legally-binding obligation to support the

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98 See Nevitt and Fabozzi, 256; Rauner, 167.
99 Nevitt and Fabozzi, 256.
financing of the project company. The reasons for this are obvious. Firstly, a straightforward guarantee obligation might infringe on the guarantee restrictions in its corporate documents or loan agreements. Secondly, a straightforward guarantee may not be welcome on a balance sheet affecting credit standing and future borrowings of the obligor.\footnote{Philip R Wood, Law and Practice of International Finance: Comparative Law of Security and Guarantees, 346 (1995).}

The terms of the comfort letter, given by the shareholders of a project company to project lenders, might include:\footnote{Id.}

1) the statement of awareness of the financing of the project company,
2) the commitment to maintain ownership interest in the project company, and
3) the promise of support required by the project lenders.

The statement of the awareness of financing has no legal effect. As to the \textit{maintenance of ownership interest}, the shareholders may declare to maintain a specified percentage interest in the sharecapital of the borrowing project company, as long as the loan is outstanding.\footnote{Wood, Comparative Law of Security and Guarantees, 347.} In other words, the intention is to assure the lenders that the shareholders are not going to abandon the project. As to the possible remedies, injunction might be available. Such a commitment, however, would hardly confer the right to damages, in case the ownership were lost and, subsequently, the project company was to become insolvent because of the shareholders not being liable for the debts of the project company.\footnote{Id.} Normally, the ownership statement in a comfort letter only supports the expectation that shareholders will not allow their project company to collapse.\footnote{Id.}

As regards the forms of financial support required by lenders, a comfort letter may commonly only contain \textit{statements of intention}, for example, “it is our intention that X-company will meet its financial obligations” or “it is our policy that the obligations of X-company will be met”.\footnote{Id.}
The shareholders may also write statements assuring that the project company is properly managed and that they will exercise their voting rights to ensure that the project company will duly fulfill its debt repayment obligations. Moreover, the shareholders may state that they will not receive money from the project company, if this was to lead to a situation where the project company would not be able to meet its obligations towards the lenders. The legal effect of the terms of a comfort letter depends on the principles of contract law and the rules of construction. One of the general characteristics of comfort letters is that the language is too vague to constitute enforceable obligations. Damages may be a possible claim, based on the breach of statements, but it might be difficult to prove that the loss suffered by lenders was directly caused by the breach.

Although a comfort letter seldom contains an effectively legally-binding obligation, it may in practice serve as effective support document as a straightforward guarantee. This is based on the fact that the infringement of statements made in a comfort letter document may damage the reputation and the subsequent borrowing opportunities of the writer of the letter.

6.2. Contractor's bonds and sponsor's completion guarantee - protection against completion risk

The completion risk is one of the principal concerns of lenders in an international project financing. Delays and cost overruns during the construction period may necessitate additional financing, and possibly renegotiation of debt repayment schedules. Contractor's bonds and sponsor's completion-guarantees are common devices for lender's protection against these risks.
6.2.1. Contractor's bonds

During the construction period of a project, the project sponsors and the lending banks are concerned to protect themselves against the contractors' and the suppliers' failure to perform as agreed in construction and equipment supply contracts. Therefore, the sponsors and the lenders require bonding from banks or surety companies. The bonds will usually constitute unconditional "on-demand" obligations in favor of the project company, either in the form of a bond, a guarantee or a standby letter of credit. The types of undertakings the contractors may be required to arrange are, typically, performance bonds, advance payment bonds, retention money bonds, and maintenance bonds.

6.2.1.1. Performance bond

Contractors of a project may get into financial difficulties and as a result become unable to complete the construction contract (completion risk). The situation of a contractor may be so bad that the construction company is forced into liquidation, and the project company or another contracting party is unable to recoup the financial losses. Such losses may be caused by subsequent delays in project completion, or increased costs when a new contractor is appointed. To cover these situations, a contractor may take out a financial guarantee in the form of a performance bond.

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111 Standby letters of credit are widely used by American banks in international transactions, as a surety by which an independent and primary obligation of the bank is established towards the beneficiary to make payment or accept a draft on presentation of certain documents. (Standby letters of credit have been created as a substitute for guarantees, which are *ultra vires* for banks in the U.S.) The undertaking normally serves as a surety in commercial transaction between the bank's customer (account party) and the beneficiary, in case of non-performance (or non-repayment) by a customer. Like letters of credit, the standby letters of credit create a primary obligation on the bank, independent of the underlying commercial transaction and its conditions and defences. See Norbert Horn, *Securing International Commercial Transactions: Standby Letters of Credit, Bonds, Guarantees and similar sureties*, in The Transnational Law of International Commercial Transactions, 282 (Norbert Horn and Clive M. Schmitthoff eds. 1982); Marti Kurkela, 132 *et seq*.


113 A.D.F. Price, 135.
Performance bond is an undertaking of a surety (bank or insurance company) towards a buyer or a customer, to provide for the proper performance of a construction contract in case the contractor fails to perform. If, for some reason, the contractor cannot complete the contract, the surety steps in and pays the client a sum of money equal to the loss incurred. In international transactions, a surety bond is often an unconditional obligation to pay on demand a sum of money, when the beneficiary considers that the contractor has failed to perform.

6.2.1.2. Other forms of contractor's bonds

As to the legal nature, the other forms of contractor's bonds required by project sponsors and lenders may be similar to performance bonds, but they are used to cover different aspects of construction. Advance payment bonds are required if the construction contract provides for the project company to make an advance payment to the contractors, in order to assist them in buying the materials and the equipment needed to start the construction. In this case, the contractor might be required to provide a guarantee to refund the advance payment in the event of its failure to perform.

The construction contract of a project may provide for the project company to retain a specified percentage of the progress payments to the construction company during the construction phase, in order to cover the rectification of defects which might not be immediately apparent. Retention bonds in an equivalent amount can be issued in lieu of payments to be retained.

Maintenance bonds can be used to cover defects and to provide the funds to correct the defaults in construction discovered after the project has been completed. It is common for performance bonds and retention bonds to be

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115 A.D.F Price, 136. As to concept of performance bond in U.S. and English practise, see Norbert Horn, 460-461.

116 A.D.F Price, 137; Clifford Chance, 73.

117 Id.
converted in maintenance bonds once construction has been completed.  

6.2.2. Sponsor’s completion guarantee

Normally, project lenders will expect substantial credit support from project sponsors, until the completion of the project is achieved and it is shown to be capable of operating satisfactorily. This credit support is commonly given in the form of a completion guarantee with full or limited guarantee for outstanding loan amounts, thus relieving the lenders totally or partially of the completion risk.  

The contents of a completion guarantee may vary. It may mean a *payment guarantee to the project sponsors* to the lenders, covering the loan until the construction of the project is achieved and it is operating satisfactorily. Thus, a completion guarantee is essentially a guarantee limited in time. In practice, there are two ways the project lenders may require the sponsor to guarantee the project loans until the project is completed. Firstly, the lenders can seek to obtain a debt claim against the sponsor by requiring him to pay a fixed sum under a completion guarantee, if completion does not occur by a specified date. Secondly, the lenders may insist that the sponsor in question provides them with a letter of credit, or bond, from a bank, with such terms that they are able to call on a letter of credit or bond if completion does not occur when it should.  

In addition, a completion guarantee may also mean an undertaking by the sponsor to the lenders, where they agree:  

1. to ensure that the project will be completed in accordance with agreed technical specifications by a long-stop date,  
2. to provide overrun finance and to contribute additional equity, if required to complete the project,  
3. to ensure that the project company satisfies certain financial test cover

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118 Id.
120 Nevitt and Fabozzi, 260.
121 Vinter, 109.
ratios, in order to establish the initial financial soundness of the project before the lenders assume the commercial risk during the operational phase of the project.

It should be noted here that if a project sponsor fails to meet those undertakings mentioned above, the remedies for project lenders may be weak. Depending on the jurisdiction in question, a court order for specific performance of such an undertaking may be difficult to obtain. The amount of damages for the non-performance of a contractual obligation, on the other hand, might be difficult to assess.\(^{123}\)

6.3. Direct debt-repayment-securing undertakings

For the purposes of this study, the obligations constituting a payment obligation directly to project lenders are called *direct* debt-repayment-securing undertakings. Guarantee is the most familiar form of direct debt-repayment-undertakings in project financing. Guarantee can be described as *the strict undertaking of a party to pay a certain sum of money to the other party under certain conditions, in order to cover a risk of that party.* Typically, the risk covered is a non-performance of another contract, the underlying or principal obligation. Any internationally uniform concept or definition of the guarantee does not exist.\(^{124}\)

In general, guarantees are used for the purpose of providing another source for debt repayment, if the original debtor cannot fulfill its contractual obligation. In project financing, this is not necessarily the only reason for lenders to take a guarantee. A borrowing project company is under the control of the sponsoring companies (shareholders) who are, in fact, the ultimate beneficiaries of the project loan, in economic terms. Here, the guarantee of the controlling sponsor companies may be taken, not only directly for credit reasons but also to ensure that the project company is operated in accordance with the lenders’ interests.

\(^{123}\) Vinter, 109.

\(^{124}\) Horn, 278-279.
6.3.1. Deficiency guarantee

Guarantees may not be required to cover the whole of the lender's credit exposure just in order to be effective tools in project financing. A lender may feel comfortable in lending to a project company, provided it is of the opinion that the project will have only limited deficits under the worst possible circumstances, and that it has an agreement by which such deficits will be made up by the guarantor.125

An ordinary deficiency guarantee (also called a first loss guarantee) is, inherently, limited in amount and designed to make up the deficiency suffered by a creditor in the event of default, of repossession of collateral, or of resale. Typically, it covers all of the lender's expenses, including the unpaid loan balance, any interest lost, and resale expenses.126 With a limited deficiency guarantee, a maximum limit is placed on the amount of the guarantor's exposure, using either an absolute (e.g. dollar amount) or a percentage figure.127 In project financing, a limited deficiency guarantee can be used in situations where a particular collateral for the loan has substantial market value.128

Example,
- the original cost of some particular project equipment is USD 100,000
- the limited deficiency guarantee of a project sponsor is determined to be 25% of the original cost of the equipment
- the amount of the loan outstanding is USD 75,000

There is a charge on the equipment and it is repossessed and sold for USD 55,000, including expenses. Here, the guarantor would be liable for USD 20,000. If the equipment was resold for USD 45,000, the guarantor would be liable for USD 25,000 dollars (the maximum limit of the guarantee).

If the creditor and the guarantor agree, a limited deficiency guarantee may be reduced on the term of the loan in proportion to the loan amortization. If this method is used, the guarantor shares in the reduction of risk facing the lender. In addition, the reduced liability of a guarantor reflects positively on its balance sheet.129

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125 See Nevitt and Fabozzi, 259.
126 Nevitt and Fabozzi, 265; Rauner, 168-169.
127 Rauner, 169.
128 Id.
129 Nevitt and Fabozzi, 265; Rauner, 169.
Example.
Limited guarantee of 20% on loan amount of ten million dollars means an initial liability limit of two million dollars for the guarantor. When the loan is amortized to nine million dollars, the guarantor is liable for a maximum of 1.8 million dollars.

It is characteristic for a deficiency guarantee that the extent of liability of a guarantor is dependent on the successful sale of a charged property. Only after the property is sold it is possible to know how much the guarantor has to pay for a guarantee. For this reason it is in the guarantor's interest to agree with the lenders (e.g. in a guarantee document) on the principles to be followed in the sale of the charged property.\textsuperscript{130}

6.3.2. Contingent guarantee

In certain circumstances, project lenders willing to finance the project company and assume most of the project risks are concerned about the most remote and/or costly contingencies. The potential loss from those contingencies might be so great that the project lenders regard themselves as unable to bear the risk. In such a situation, the project company's shareholders or other third parties may be willing to provide a contingent guarantee under which the guarantor agrees to meet the project company's obligations, in case a specific contingency occurs\textsuperscript{131}

The guaranteed contingency may be defined in various ways in the guarantee document. For example, the contingency may be deemed to occur in case of a number of events, such as the failure of other interested parties to the project financing arrangement in performing or paying, after reasonable efforts by the lender(s) to enforce performance or collection.\textsuperscript{132} Further, the contingent guarantee may take the form of some event beyond the control of the parties. Typically, the contingency may be an unlikely event, such as a change in market price, an action of government, or some uninsurable act of God.\textsuperscript{133} Given a small likelihood of the possibility of the guarantor performing under such guarantees, the impact of providing these should be minimal on the


\textsuperscript{131} Nevitt and Fabozzi, 260; Rauner, 171.

\textsuperscript{132} Nevitt and Fabozzi, 260.

\textsuperscript{133} \textit{Id.}\end{quote}
6.3.3. Loan purchase agreement

The general principle is that the change of a creditor is valid even without the debtor's consent. Thus, the liability to pay the debt of a project company may be arranged by entering into a purchase agreement, whereby the project sponsors agree with the lenders to purchase the amount of their loans in the event of a project company's default. The main difference between a purchase agreement and a straightforward guarantee is that the breach of purchase agreement, depending on the applicable law, may result in damages — but not a liquidated demand for the whole debt. The obligation to buy the outstanding loans can hardly meet the off-balance sheet objectives under the well-developed national accounting standards.

6.3.4. Repurchase agreement

As mentioned above, a project company is financed through the combination of debt capital and equity. Project sponsors may make their equity investment to a project company either in cash or in kind contribution. The project company frequently grants the project lenders a maximum security on the project assets. Here, the project lenders are interested in the value which the contribution in kind item (e.g. in form of a plant, equipment, machinery or other capital goods) has as collateral for the loan. It also should be noted here that the project sponsors and the lenders are not necessarily unanimous as regards the market value of the contribution in kind. However, the project sponsors may assure the value of their contribution in kind by entering into a repurchase agreement with the project lenders.

In a repurchase agreement, the shareholder(s) of a project company, for example, may agree with the project lenders to purchase a particular asset of the project company at a predetermined fixed price, in case the project company has become insolvent and the project lenders as secured creditors cannot sell the asset in question elsewhere at a minimum price determined in

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134 Rauner, 171.
135 Wood, Project Finance, Subordinated Debt and State Loans, 22.
6.3.5. Cross-default clause

The legal instruments discussed above involve a legally-binding obligation to perform for lenders under certain conditions. In certain situations, it is conceivable that a cross-default clause in the sponsoring company’s own credit agreement might give enough credit support to satisfy the project lenders, not by obliging but in practice forcing the sponsoring company to assume liability for the debt repayment of the project company.138

Cross-default can be defined as an event of default triggered by a default in the payment - or by an actual or potential acceleration of the repayment -of other indebtedness of the borrower or another person.139 It is conceivable that a project sponsor and a project lender, in order to support the financing of a project company, would agree to cross-default clauses existing in the sponsoring company’s own credit agreements, to be applied to the project company’s project loan agreement (and possibly other contracts too). As a result, if the project company would be in default, the sponsoring company would be in default as well, as regards its own credit agreement. If the continuance of the sponsoring company’s own credit agreement is of such an importance for it that it cannot be let accelerated, the lender could be confident that the project company debt will be paid, since the interested party would pay off the project company’s debt rather than allow its own loans to be accelerated.140

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137 Interview March 19, 1997. Jukka Ahmala, General Counsel. Finnish Fund for Industrial Cooperation Ltd. Also, put options concerning specified project assets can be used to establish a floor value for the project. A put option can be provided that entitles the lenders to put specified project assets to a third party, in the event of default under the financing agreements. Once such a put option is exercised, the third party is required to purchase the relevant assets. See Robert L. Drake, A Security Problem. Trade Finance, 30 (Euromoney Publications, January 1992).

138 See Nevitt and Fabozzi, 266.

139 Clifford Chance, 102.

140 See Rauner, 176.
6.4. Indirect debt-repayment-securing undertakings - support agreements

Support agreements often are an essential part of the project financing arrangement. They constitute a payment or other performance obligation in favor of the project company. Economically, these agreements, nevertheless, have a function of quasi-guarantee, since they assure the cash flow or the funds to the project company, which is required to continue operations and pay the debt service, even if the project is not performing. Typically, the project company assigns its rights under the support agreements to the project lenders. The combination of unconditional payment obligation in a support agreement, and the assignment of rights under it, may in practice give lenders nearly as much comfort as a straightforward direct guarantee.

6.4.1. Investment agreements

Under an investment agreement the project sponsors or shareholders agree to provide financial support to the project company. Typically, investment agreements take the form of a working capital maintenance agreement or a cash deficiency agreement. Under a working capital maintenance agreement, the project sponsors agree that they will finance the project company, by way of subordinated loans or equity capital, in sufficient amounts to ensure the solvency of the project company or to meet certain prescribed financial tests, such as a specified minimum working capital ratio. Under a cash deficiency agreement, the sponsors may agree that they will pay to the project company sums equal to the amounts which are required to service and repay the loan. These agreements, in many cases, may be made between the sponsors and the project company. The rights of the project company under the agreement are then immediately assigned to the project lenders. Here, the lenders as assignees cannot get a better right than the project company originally had as an assignor under the agreement.

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141 Harries, 355.
142 Id. 356.
143 Wood, Law and Practice of International Finance, 318; See also Clifford Chance, 70.
144 Id.
145 Wood, Law and Practice of International Finance 318.
A claim for breach of an investment agreement might prove to be difficult in practice. The remedy for breach is damages, and usually there is no right to compel the "guarantor" to invest.\(^{146}\) The lenders would have to prove actual financial loss and they would also have an obligation to mitigate that loss. In order to prove the loss, it might also be necessary to first enforce security and use all the other possible remedies that the lenders might have against the borrowing project company and the project sponsors.\(^{147}\) Moreover, the obligation to invest may not be performable if the debtor (the project company) is in liquidation, because the debtor is no longer entitled to borrow or issue shares.\(^{148}\)

6.4.2. Take-or-pay contract

Since in project financing the debt repayment of a borrowing project company is largely dependent on sufficient cash flow during the term of the loan, the critical question for project lenders is whether the project company can sell its production (goods or services) at a price which covers operational costs and debt service. Price fluctuations in the sales markets of a project's end product may thus adversely affect the debt repayment ability of the project company. Ensuring sufficient cash flow and protection against lower prices or lack of demand of a project's end product may be achieved through various forms of forward sales agreements, i.e. through the conclusion of long-term, price-specific sales contracts with the customers, before the production begins.\(^{149}\) It should be noted that pre-selling to customers frequently carries a cost for the project company, since the pre-buyers will expect a favorable price in return for their commitment.\(^{150}\) This cost can be regarded as an insurance premium -the project company ensures for itself a pre-determined revenue stream in return for reduced prices. In addition, the project company (the seller) loses the opportunity to take advantage of possible later price increases. Normal long-term sale contracts do not assure that the project will be able to meet its debt

\(^{146}\) Wood, Comparative Law of Security and Guarantees, 355.

\(^{147}\) Clifford Chance, 70.


\(^{149}\) T H Donaldson and J P Morgan, 14-15; Rauner, 171-172.

\(^{150}\) T H Donaldson and J P Morgan, 15.
service obligations, even if they appear to ensure a cash flow that would be sufficient for debt service purposes. This is because the sales contracts normally obligate buyers to make payment only upon delivery of the goods or services purchased, or upon delivery of documents representing the goods. In order to deal with this problem, the project lenders often insist that the project company obtains take-or-pay contracts from the sponsors of the project.\footnote{See Rauner, 172.}

The take-or-pay contract has two main parallel objectives: to protect the project and the project lenders against the sales market risk, and to serve as an indirect debt repayment obligation. Under a typical form, the project sponsor enters into a purchase agreement with the project company under which the sponsor agrees to buy all the project production, goods or services, or a certain portion of them. The project company then pledges or assigns its rights under the take-or-pay contract to the project lenders.

The project lenders, to a certain extent, may rely upon the take-or-pay contracts for repayment of their loans. The basic idea of a take-or-pay contract is to approximate the trading contract to a loan obligation. The take-or-pay contract can be defined as a long-term agreement between a purchaser (a project sponsor) and a seller (a project company), involving an unconditional contractual obligation to make periodic payments in the future for fixed or minimum amounts or quantities of products, goods or services, at fixed minimum prices.\footnote{Nevitt and Fabozzi, 276.} If the project lenders rely solely upon a take-or-pay contract for repayment of their loans, the payments must be in an amount sufficient to cover the operating costs of the project and the loan payments.\footnote{Nevitt and Fabozzi, 276.}

Characteristic for the take-or-pay contract is that the payment obligation of a purchaser is, as far as possible, unconditional, \textit{i.e.} the payment must be made whether or not the services are actually rendered or the goods actually delivered.\footnote{Id.; Wood, Law and Practice of International Finance, 317.} The obligation is either not cancellable or it is cancellable only with the consent of the other party, or in the event of some remote contingency.\footnote{Nevitt and Fabozzi, 276.}

\begin{footnotes}
\item[151] See Rauner, 172.
\item[152] Nevitt and Fabozzi, 276. As to definiton, see also Clifford Chance, 70 and 109.
\item[153] Nevitt and Fabozzi, 276.
\item[154] Id.; Wood, Law and Practice of International Finance, 317.
\item[155] Nevitt and Fabozzi, 276.
\end{footnotes}
The take-or-pay contract can take different forms, depending on the nature of the project in question. Generally, the take-or-pay contract may be a contract for:

- the purchase of goods produced by a project, such as minerals, hydrocarbons or manufactured goods, or
- the purchase of services, such as the processing of a product or the use of a pipeline (known as throughput contracts) or use of a transportation system (known as tolling agreements).

Each type of take-or-pay contract will be subject to different legal rules, e.g. a sale of goods contract will be subject to sale of goods legislation, unlike it is in case of tolling agreements, but the underlying principles discussed above remain the same.\(^{156}\)

In its most extreme form, the nature of an obligation to pay is absolute and, under the so-called hell-or-high-water clauses, not limited by any events, in particular not by force majeure.\(^{157}\) The absolute nature of payment obligation of the take-or-pay contract may, however, give rise to several legal problems and considerations. If the project company providing goods or services to the buyer under a take-or-pay contract fails to comply with the terms of the contract, the buyer might be able to reduce the purchase price or cancel the contract. As a result, the credit support, provided by a take-or-pay contract for the project lenders, would be reduced or cancelled as well.\(^{158}\) Therefore, firstly, the project company’s obligations as a seller (e.g. liability for delays in delivery or defective goods), under the take-or-pay contract, should be agreed to minimum. Otherwise, there would be a major risk of breach of contract enabling the buyer to counterclaim or cancel the contract. For this reason, the buyer should agree to pay e.g. "for the expectation of the goods or services".\(^{159}\) Secondly, special attention should be paid on the applicable law, which may imply certain obligations to the project company as a seller. These implied obligations affecting the project company should be excluded, if possible.\(^{160}\)

\(^{156}\) See Wood, Law and Practice of International Finance, 318.

\(^{157}\) Nevitt and Fabozzi, 276; Harries, 356.

\(^{158}\) See Wood, Law and Practice of International Finance, 320.

\(^{159}\) Id.

\(^{160}\) Id.
Thirdly, especially if common law principles are applicable to the take-or-pay contract, the project company should be protected against the effect of the doctrine of frustration of the contracts. Under the doctrine of frustration, the obligations of the parties automatically terminate in situations where events render impossible the further performance of the contract and the contract omits to make provision for these possible events.\textsuperscript{161} If a take-or-pay contract is frustrated and therefore terminates by operation of law, the credit support for the financing of the project company terminates as well. Therefore, the take-or-pay contract should specifically identify events deemed not to be within the doctrine of frustration.\textsuperscript{162}

The extreme form of a take-or-pay contract described above protects against the market risk as well as the operating risk of a project. In broad terms, the take-or-pay contract, combined with the assignment of the sellers’ rights under it by way of security to the project lenders, serves nearly the same function as a corporate guarantee. Under the strict payment obligation, determined in the take-or-pay contract, the buyer in effect takes responsibility for the payment of the project loan.

6.4.3. Exclusive supply agreement

In case the goods produced by the project company are inevitable for the project sponsors, but they are considering themselves unable to oblige to buy the project company's production at predetermined fixed prices, it might be possible for the project lenders to accept an \textit{exclusive supply agreement} as a substitute for a take-or-pay contract. Under an exclusive supply agreement between the project company and the sponsoring company, it is agreed that the latter will not purchase similar goods from any other source for a predetermined time period.\textsuperscript{163} If the sponsoring company is a creditworthy enterprise with good business prospects, such an agreement, although not expressly obliging it to make payments to the project company, would give the lenders good grounds for believing in a sufficient cash flow being received by the project company for the debt servicing purposes. An exclusive supply agreement

\textsuperscript{161} As to doctrine of frustration, see \textit{e.g.} Hugh Collins, The Law of Contract, 332 (2nd ed. 1993).

\textsuperscript{162} Wood, Law and Practice of International Finance, 321.

\textsuperscript{163} See Rauner, 175.
agreement may effectively protect the project lenders against the sales market risk of the project's production, and could be used to support financing of the project company in case guarantees are not available and/or other debt repayment ensuring obligations have to be supplemented.\textsuperscript{164} However, when project financing arrangements involve exclusive supply agreements, the parties should be sensitive in taking into consideration the relevant provisions of competition law.

6.4.4. Supply-or-pay contracts

Previously, the focus has been on the buyers and on those obligations which are protecting the project lenders against the sales market risk (and at the same time ensuring income for the project company). As regards the put-or-pay or the supply-or-pay contracts, the focus is on the supply markets and the suppliers of the project.

Supply-or-pay or put-or-pay contracts are long-term contracts made between a project company and the suppliers of energy, raw material or manufactured goods. Under these contracts, the supplier (typically a project's sponsor) is obliged either to supply energy, raw material or products at a fixed price, or to pay to the project company the difference in costs incurred in obtaining the supplies from another source.\textsuperscript{165} Similarly to a buyer's obligation under a take-or-pay contract, the suppliers' obligation to perform under the supply-or-pay contract should be agreed, as far as possible, unconditional. The essence of supply-or-pay contracts is that they fix the operating costs of a project to a certain predictable level, thus, in part, ensuring that the income cash flow of the project company is sufficient to service the debt for project lenders.\textsuperscript{166}

\textsuperscript{164} Id.

\textsuperscript{165} Nevitt and Fabozzi, 277; Clifford Chance, 72.

\textsuperscript{166} Id.
7. PROJECT LENDERS' PRIORITY RIGHT TO PROJECT ASSETS

7.1. Ranking of investors and types of capital in respect to a project company's assets

Project financing involves different types of investors, and different types of financing, i.e. equity contributions or subordinated loans of the project sponsors, unsecured loans, and secured loans. Each type of financing confers a different ranking on the investors' claims against the project company's assets. The order of priority in which the investors' claims to corporate assets are satisfied, is basically determined by agreement concerning the claim, the security interest law, the bankruptcy law and the law on winding up of a corporation. As already discussed above, one of the main factors which the riskiness of a claim depends on is the priority assigned to the type of claims in bankruptcy statutes.\(^\text{167}\)

There are three main types of capital available to finance a project company: equity, quasi-equity and senior debt. \textit{Equity investment}, in the form of share capital, represents the risk capital in project financing. \textit{Quasi-equity} may be invested by the project sponsors in the form of subordinated loans.\(^\text{168}\) Subordinated loans are senior to equity capital, but junior to senior debt and secured debt. Equity and quasi-equity provide, for lenders, the basis to advance more senior forms of capital to the project company.\(^\text{169}\) From the lenders' point of view, equity and quasi-equity protect against project risks, especially against

\(^{167}\) Rapakko , 226

\(^{168}\) Subordination is a transaction whereby one creditor (junior creditor) agrees not to be paid by a borrower or other debtor until another creditor (the senior creditor) of the common debtor has been paid. Two forms of subordination may be distinguished. \textit{Inchoate subordination} means that payments can be made on the junior debt until the borrower's liquidation or until the commencement of other insolvency proceedings. Like security, inchoate subordination is relevant only if the debtor is insolvent, because until then both junior and senior creditors can be paid in full. In \textit{complete subordination}, no payments may be made on the junior debt until the senior debt has been paid. This form is commonly used to subordinate the debt of "insiders", such as parent companies or other shareholders, as a condition of bank loans, especially in the context of project financing. \textit{See} Wood, Law and Practice of International Finance, 403; Wood, Project Finance, Subordinated Debt and State Loans, 37.

\(^{169}\) Price, 45.
the pre-completion risk. Equity also protects against operational and market risks that might cause cost-overruns leaving too little cash flow to be used to service the debt.\footnote{Donaldson, 13.}

Senior debt can take the form of either unsecured or secured loans. Most borrowings from commercial lenders for project financing will be in the form of senior debt. Senior debt has priority of payment on the borrower's liquidation. Commercial loans are the most important source of senior debt for project financing.\footnote{Price, 46.}

All investors may suffer losses if project risks materialize, but the equity investor (shareholder of a project company) is the first to suffer a loss, and most seriously affected. The equity investor has the highest risk, but also the highest profit if the project is successful. The most senior ranking creditors, \textit{i.e.} the secured lenders, are best protected in a project crisis, but they still may suffer losses after the lower ranking equity investors and creditors have lost their investment.\footnote{See Harries, 358.}

\section*{7.2. Unsecured project loans and contractual protection of project assets against other creditors}

It is common in project financing for the lenders to take security over the project assets as far as this is possible under the laws of the country where the assets are located. However, there might be reasons why it is inappropriate or impossible to obtain such security.\footnote{See Clifford Chance, 63.} Unsecured project loans, which are not secured by a security interest in any project company's assets, may be available for the financing of a project, provided that the sponsors of the project have established a good reputation with the financial community and provided that sufficient share capital or subordinated loans have been invested to meet the equity risk capital requirements of the project.\footnote{A.D.F Price, 46.} However, the unsecured project lenders' objective is to ensure, as far as possible, that if the borrowing project company should become insolvent, the greater part of its assets would
be available for distribution amongst its original unsecured lenders, and would not be dedicated to cover the loans of other unsecured or secured creditors.\footnote{175}{See McCormick, 181.} This objective can be achieved by including various types of covenants in a project loan agreement, \textit{e.g.} restrictions on borrowing and pledging of assets. In order to protect themselves, the unsecured project lenders may demand the borrowing project company to promise that it shall not make any other borrowings exceeding agreed borrowing limits or without a consent from the project lenders.

Another protection available for unsecured project lenders is to demand that the borrower commits itself to a \textit{negative pledge} clause in a loan agreement. A negative pledge is \textit{an agreement by the debtor not to encumber its assets in favor of the third party} (or not to encumber them by way of a security which would rank ahead of, or \textit{pari passu} with the security given to the lender).\footnote{176}{R. M. Goode, \textit{Legal Problems of Credit and Security}, 5 and 17 \textit{et seq.} (2nd ed.1988). In the simplest form, the negative pledge might state: “So long as any of the loans are outstanding the borrower will not create or permit to subsist any mortgage, charge, pledge, lien or other encumbrance on its assets or revenues.” See Wood, \textit{Law and Practice of International Finance}, 147.} Since a negative pledge does not confer rights on any asset of the debtor, but merely restricts his ability to give security to others, it does not constitute a security interest.\footnote{177}{\textit{Id.}}

The negative pledge is often coupled with a \textit{pari passu} undertaking, in which the borrower agrees, as far as possible, not to allow any other creditor to obtain priority over the credit given by the lender to whom the undertaking is given.\footnote{178}{McCormick, 181.} The purpose of the \textit{pari passu} undertaking is to establish an equal treatment for the unsecured creditors.\footnote{179}{Urpo Levo, \textit{Ulkomainen luotonotto}, 73 (1985).} A negative pledge is a contractual commitment that, unlike a security interest, does not confer rights to possession, or control or sale of the borrower's assets. Being contractual obligation and binding only \textit{inter partes} in a debtor-creditor relationship, it does not confer any priority on the claims of the lender in the event of bankruptcy or liquidation.\footnote{180}{See Clifford Chance, 63.}
Breach of a negative pledge frequently constitutes an event of default under the project loan agreement. Thus, the lender may react to the breach by accelerating the loan and calling for immediate payment. This, however, would be practical only if the project company borrower had sufficient funds for debt repayment. This is not usually the case if the debt is expected to be repaid mainly from the future cash flows generated by the project.

For having breached its contractual obligation under the negative pledge clause, the project company borrower might be liable for paying damages. However, this probably would be little comfort to the lender if the project assets, on which the security interests is created in favor of another creditor, were relied on as a major source of repayment.

If the borrowing project company creates a security interest in favor of a third party, in contravention of the negative pledge, it is likely that in most jurisdictions the security would be regarded as valid. In cases where the third party knew, or should have known, of the existence of the negative pledge, the lender might be able to challenge the validity of any security created in breach of it. In any case, the ability to challenge would very much depend on the circumstances of the case and on the rules of the relevant legal system. In some jurisdictions, there are examples of situations where an obligation given by one party may confer, to a certain extent, protection in favor of an obligee against a mala fide third party. It is possible that, in some jurisdictions, there are grounds for the courts to consider that, although the creation of a security interest in a breach of negative pledge is valid, the mala fide security holder is liable for paying damages to the party to whom the negative pledge undertaking was given.

7.3. Secured project loans

Secured commercial loans are available to most projects where the assets securing the debt have value as collateral. Such assets should be marketable and readily convertible into cash. Project financing involves a variety of security arrangements. The collateral of real property, the payments due under

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181 Id.
182 Id.
long-term sales contracts, and the assignment of contractual rights are all used as collateral in project financing. The availability of effective security on project assets can have a significant effect on the structure of the project financing arrangement, and on the overall allocation of risks and recourse between the parties involved. In the following pages, the focus is on the role and purpose of a security as the means of protection for project lenders.

### 7.4. The legal nature and effectiveness of a security interest

In project financing, by definition, the lender principally looks to the cash flows and earnings of the project as the source of funds for repayment, and to the assets of the project as collateral for the loan. Ideally, the security arrangement in project financing should cover all the project company’s assets. This, however, is not always possible in all jurisdictions.

Generally, a security interest can be defined as *a right given to one party in the assets of another party to secure payment or performance by that other party or by a third party* A lender taking security for an advance is concerned to see that if the debtor’s assets are insufficient to meet the claims of all his creditors, the lender will at least be able to look to his security to obtain total or partial payment. To be effective, the security interest will have to confer to the lender’s claim priority over the claims of the other parties asserting rights over the same asset, especially priority over the attaching creditors’ and the bankruptcy creditor’s claims. Moreover, to be effective, a security interest should confer to the security holder a better right to the assets, in respect of competing purchasers and mortgagees of the assets in question.

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184 Clifford Chance, 64.
185 As to definitions of project financing, see page 1 and 15 above.
187 Goode, 1.
188 Id.
189 See e.g. Wood, Comparative Law of Security and Guarantees, 167-168.
7.5. Aspects on creation of security in a project’s host country

It is common in project financing for the lenders to take maximum security over the project assets, as far as this is possible under the laws of the country where the assets are located.\(^{190}\) Security interests on the project company's real property, such as land, buildings, equipment and goods, have to be established under the local security law. The law of the country where the object is situated (\textit{lex rei sitae}) determines the effectiveness of the security interest, \textit{i.e.} a security holder's right in respect of third parties, like attaching creditors, bankruptcy creditors, competing purchasers of the object and subsequent mortgagees. Local law also provides the legal framework for enforcing the security interest.\(^{191}\)

Projects are often carried out in countries whose laws and legal systems are unfamiliar to the lenders. The project lenders, therefore, at an early stage, should carry out at least a preliminary analysis of the fundamental questions concerning the legal framework, for creation of security in the project's host country. The preliminary investigation should include at least the following issues.\(^{192}\)

1) Which project assets can a security be created on?
2) Are there any restrictions on the foreigners taking security, especially on land, and what kind of permits should be received from the relevant authority?
3) Can security be created on user rights as well as on ownership rights?
4) What formalities need to be complied with to perfect the security interest, \textit{e.g.} notarizations, registrations and stamp duties?
5) Can security on movable assets be created without physical transfer of those assets to the mortgagee or the pledgee? In other words, is a floating charge possible?
6) Does the established security interest attach after-acquired property, like buildings and fixtures attached to mortgaged land?
7) What is the order of priority on the liquidation of a project company and which creditors will, by law, be preferred over a secured creditor?
8) Can a junior mortgagee prejudice the position of a senior mortgagee? There are two possible disadvantages of allowing junior mortgages on the same asset. Firstly, the junior mortgagee may have an independent right to enforce the security. Secondly, the presence of a junior

\(^{190}\) Clifford Chance, 63.

\(^{191}\) See Kaarina Buure-Hägglund, \textit{Irtaimiin esineisiin kohdistuvat reaalivakuudet}, 89 (1978); Mettala, 222.

\(^{192}\) See Wood, Law and Practice of International Finance, 327-331; McCormick, 186-187; Clifford Chance, 65.
mortgagee may prevent the senior mortgagee from advancing additional debt having senior priority.

9) Can security be held by an agent or trustee for a group of creditors whose members might change from time to time (e.g. through transfer of their participation in the loan facility to another bank)?

10) Must there be a court order to enforce the security?

11) Is the private sale of a security object possible, on enforcement, or must there be a court sale or a public auction?

12) Can the secured lenders, as an alternative to sale, take possession of the security object on a default and collect the income from the security?

13) Should the mortgage debt be expressed in local currency, even though the loan itself is denominated in a foreign currency? Here, the risk for the lender is that if the value of the local currency were to decline in respect to the currency of the loan, the lender might find himself unsecured for the difference.

14) Does the local exchange control regulation permit the repatriation of the proceeds of a sale of security?

7.6. The purposes of security in project financing

The realization purpose of security. Usually the purpose of security is to enable the lender, in an event of default under the loan agreement, to sell the asset on which the security is taken and to use the proceeds to pay out the outstanding loan amounts ahead of other creditors. In project financing, this purpose is important if the project assets include specific tangible assets which can be separated from the project and sold elsewhere on the open market. However, it is often unlikely that the realisable value of the project assets would significantly cover the debts owed to the project lenders. For example, assets like land, equipment and machinery are often valuable only for the operation of the project. Therefore, the value of the project assets may well be minimal for the third parties, unless they are willing to take over the running of the project.

The defensive purpose of security. Although the ultimate purpose of taking security is always to secure the debt repayment, the ability to sell the project assets may be an important, but not necessarily the primary reason for taking security on project assets. In project financing, the main purpose of taking

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193 See Wood, Law and Practice of International Finance, 326; Vinter, 80.

194 See Clifford Chance, 66 and 68; Vinter, 80.
security on project assets is often *defensive*. \(^{195}\) Most project lenders do not consider that the prime purpose of the security is to give them the right to sell the debtor's assets, as they would in a more conventional secured financing. The common view is that in most cases the purpose of taking security is to prevent any third party from acquiring property rights in priority to the lenders; if a lender has security on an asset, he ranks ahead of the unsecured creditors, and the ability of the unsecured creditors to interfere adversely in the relationship between the debtor and the secured creditor is thereby limited. \(^{196}\) In project financing, the logic behind the defensive purpose of security is that unsecured creditors would have little to gain by pursuing a disruptive action against the project company, *e.g.* attaching a crucial project asset. And even if the unsecured creditors took such an action, it is expected that the project lenders would, to a large extent, be insulated from its effects. \(^{197}\)

*The taking-over purpose of the security.* Depending on the security and enforcement laws of the relevant jurisdiction, security arrangements may enable the lenders to take over and use an asset as opposed to merely selling it. \(^{198}\) In project finance, the ability of the lender to exercise operational control over the project assets can be more important than the ability to realize the assets by sale. As mentioned above, the project assets often are not marketable in practice, because of the nature of the assets. In such a case, the security over project assets may be taken in order to enable the lenders to take over the project and to operate it for his own benefit, and possibly, to sell the project as a going concern. \(^{199}\)

*The political risk insulation purpose of the security.* The materialization of political risks (discussed in chapter 5.2 above) may adversely affect the project company's debt repayment ability. For this reason, it is important that security is taken on the project company's assets outside the jurisdiction of the project's host country. Typically, this involves taking security on export proceeds and using escrow accounts to receive those proceeds. \(^{200}\)

\(^{195}\) See Vinter, 80; Wood, Project Finance, Subordinated Debt and State Loans, 30; Clifford Chance, 66; McCormick, 188.

\(^{196}\) McCormick, 188; Vinter, 80.

\(^{197}\) Vinter, 80; Wood, Project Finance, Subordinated Debt and State Loans, 30.

\(^{198}\) *Id.*

\(^{199}\) Wood, Law and Practice of International Finance, 326; Clifford Chance, 66.

\(^{200}\) See Rose, 47; Wood, Law and Practice of International Finance, 322.
Ideally, the security should cover all the project assets. Altogether, the security arrangement concerning project assets typically includes the following security interests:

- mortgages on the land and the facilities
- charges on inventory and equipment and other moveable goods
- assignment of sales proceeds under the long term sales contracts
- charges on bank accounts into which the proceeds of the sale of products are paid
- assignment of rights under the project company’s long term sales contract, long term supply contracts and other possible project contracts

Charge are also made on the shares of the project company representing ownership of the project assets. Each of these security interests may serve different purposes, from the project lenders’ point of view.

7.6.1. Mortgages on land and facilities

The market value of the land, the buildings and the facilities might be minimal, since those assets may have only little value except for those parties who are willing to run the project in question. Frequently, the project lenders will ask for mortgage, if available, for defensive purposes in order to preclude the borrowing project company from granting a security interest in its key assets to other creditors.

7.6.2. Charges on inventory and equipment and other moveable goods

In many projects there will be some marketable tangible assets which can be separated from the project and sold on the open market. Security on these assets may be taken for both realization and defensive purposes. Since inventory, equipment and other moveable assets are needed in the day-to-day operation of the project, it should be possible to take security on these moveable assets, without physical transfer of those assets to the mortgagee or pledgee. This may be difficult in those jurisdictions which do not recognize a

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201 As to elements of security arrangements in project financing, see McCormick, 189; Wood, Project Finance, Subordinated Debt and State Loans, 31; Clifford Chance, 68.

202 Rendell and Niehuss, 44.
floating charge. A floating charge is available in most common law countries, and at least five non-common law countries have created a general floating charge by statute for commercial businesses or corporates, namely: Finland, Norway, Scotland, Sweden, and Russia.\(^{203}\)

Generally, a floating charge is a charge on all the assets of the company, but it does not prevent the company from disposing its assets in the ordinary course of business. As regards the English floating charge, the debtor can deal with the property in the ordinary course of business until the charge crystallizes on a default.\(^{204}\) It allows the debtor to collect his recivables and use the cash. The debtor can sell goods without any consent of the creditor, and the purchaser is free of the charge. The English floating charge covers the future property. Accordingly, there is no need to identify and mortgage each asset when it comes into existence. The English floating charge becomes a fixed charge on enforcement ("crystallization") and it is enforceable by the appointment of a "receiver", who is a possessory manager entitled to operate the entire assets subject to the charge. Hence, the business can be operated as a whole for the creditor. Moreover, the business can be sold as a whole. Accordingly, its value can escape being diminished by a piecemeal sale of individual assets or by a time-consuming public auction.\(^{205}\) It is quite easy to see that the English type of floating charge might effectively serve the realization purpose and the taking over purpose of a security in project financing.

The Finnish floating charge (yrityskiinnitys) shares some characteristics with the English floating charge. Taking the Finnish floating charge as another example, it covers, primarily, the current assets of a company, i.e. financial assets, inventories and fixed assets, including patent and other industrial rights, but excluding land. According to the relevant act (yrityskiinnityslaki), a floating charge does not cover any assets which may be charged other than under the floating charge. Thus, a floating charge cannot, normally, be created over land, vessels, aircraft and certain vehicles, since such assets can be otherwise

\(^{203}\) See Wood, Comparative Law of Security and Guarantees, 15 and 16.

\(^{204}\) F.H. Lawson and Bernard Rudden, The Law of Property, 201 (2nd ed.1982); Wood, Comparative Law of Security and Guarantees, 12.

\(^{205}\) As to the main characteristics of the English floating charge, see Wood, Comparative Law of Security and Guarantees, 12.
charged. It is possible, that in certain circumstances buildings, which are situated on land not owned by the chargor or held by him as lessee, are covered by a floating charge. Any new current assets received by the company will automatically come under the cover of the Finnish floating charge.

As mentioned above, the Finnish floating charge does not cover all the debtor's assets. It is not enforceable by the appointment of a receiver. Compared to the English floating charge, the security given to the lender by the Finnish floating charge is much weaker, both in terms of the realization and in taking-over purposes of a security.

7.6.3. Assignment of sales proceeds under long term sales contracts

The most widely used security device in international project financing is an assignment of the hard currency proceeds of the project company, derived from the long term sales contracts covering the project's output. If the purchaser's payment obligation under the contract is unconditional, as it is under a take-or-pay contract, then the security created by the assignment of the proceeds under that contract will be a valuable and crucial part of the financing arrangement. The combination of unconditional payment obligation in the take-or-pay contract and the assignment of sales receivables under it by way of security to the project lenders forms a unique type of security arrangement having some characteristics of both personal security and real security.

The assignment of sales receivables by way of security has the effect of creating security interest in favor of the lenders in the receivables under the long term sales contracts. When perfected, the security interest thus created should give the lenders a prior legal right to the project's revenues. The

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206 Ilmari Ojanen and Juhani Sutinen, Yrityskiinnitys, 41 et seq. (2nd ed. 1991).
207 Rendell and Niehuss, 42.

208 Generally, the legal nature of the assignment of receivables under a sales contract may be, e.g. 1) assignment of receivables for collection, i.e. the so-called inkasso-transfer of receivables, 2) sale of receivables, 3) assignment of receivables for debt repayment (datio in solutum), and 4) assignment of receivables by way of security. As to the legal nature of the assignment transaction concerning receivables under a contract, see Jarno Tepora, Factoring sivullissuojan näkokalmasta, in Juhlajulkaisu Matti Ylöstö 1917-4/2-1987, 423-426 (1987).
210 Rendell and Niehuss, 42.
security arrangement concerning the project company's export receivables involves the following basic elements: 1) the long-term export sales contract (ideally a take-or-pay contract discussed above), 2) the actual assignment transaction, and 3) the trust account arrangement securing the funds to received from the purchasers under the long term sales contracts, for the benefit of the secured lenders and keeping them outside the jurisdiction of the borrowing project company's host country. This type of security arrangement often requires an irrevocable approval from the exchange authorities (central bank) in the project company's host country.  

The assignment transaction involves the assignment agreement between the assignor (project company) and the assignee (project lenders or a trust appointed by them), and, in many jurisdictions, a notification to the debtor (purchaser under the long term sales contract) of the assignment. To be effective in securing the debt, the assignment has to be enforceable, not only against the principal debtor (project company) and the account debtor (purchaser), but also against third parties. The formality requirements of the assignment which have to be fulfilled may vary considerably under the laws of different jurisdictions. In some jurisdictions there are no formalities at all, some require an assignment agreement in writing and notification for, or acceptance by, the account debtor, and some require registration of the assignment.

As the assignment is the instrument which creates the security interest in the receivables, it should be made in accordance with the relevant laws in order to perfect the lender's interest and thereby establish its prior position as a secured lender. To ensure that the security interest will be valid, effective and enforceable in all the relevant legal relationships, the formal requirements of the assignment, to be sure, should be fulfilled according to the following laws: 1) the law of the seller's domicile, i.e. the project company's host country, 2) the law of the purchaser's domicile, 3) the law governing the long term sales contract, and 4) the law of the country in which the trust account receiving the sales receivables is located.

The assignment of export proceeds is frequently combined with a trust account arrangement. The hard currency proceeds under the long-term export

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211 See Harries, 354; Rendell and Niehuss, 42.


213 Rendell and Niehuss, 42. See also Harries, 354.
contracts, pursuant to the terms of the assignment, will be paid directly into a trust account. Typically, the trust account will be established outside the project company's host country, often in a financial center like New York or London.\textsuperscript{214} The trust bank receives the proceeds derived from the export contracts and retains, accumulates and distributes the amounts required for the debt service to the secured lenders, and releases the balance to the project company, which may be bound to deliver these export earnings to its central bank.\textsuperscript{215}

The project company is subject to the foreign exchange laws of the jurisdiction in which it is established. Therefore, the project company may need a special licence or permit from the exchange control authorities for the arrangement involving the assignment of export proceeds and holding of foreign currency accounts abroad.\textsuperscript{216} For project lenders, the holding of a foreign trust account is an attempt to avoid both the legal problems of enforcement and the political risk inherent in leaving the export proceeds of the project product to accumulate within the jurisdiction of the project's host country.\textsuperscript{217} In other words, the objective of the security arrangement concerning the project company's export receivables is mainly to serve the realization purpose and the political risk insulation purpose of the security in project financing.

7.6.4. Direct agreements and assignment of rights under the project company's commercial contracts

The overall security arrangement of project financing often involves the assignment of rights under the long-term supply contracts (ideally a put-or-pay contract made between the project company and the suppliers of energy, raw materials or manufactured goods) and the long-term sales contracts (ideally a take-or-pay contract made between the project company and the purchasers of the project's end-product, goods or services) to the project lenders.\textsuperscript{218} In

\textsuperscript{214}RendellandNiehuss,43.

\textsuperscript{215}Harries, 354.

\textsuperscript{216}Rose, 47; Harries, 354.

\textsuperscript{217}Rose, 47.

\textsuperscript{218}Clifford Chance, 59.
addition, direct agreements may be entered into between the project lenders and the parties of the contracts mentioned above, i.e. suppliers under the long-term supply contracts and purchasers under the long-term sales contracts. Direct agreement may also be made between the project lenders and the contractor under the construction contract.\(^\text{219}\)

The purpose of the direct agreement is to enable the project lenders to step in and substitute the project company under the commercial contracts if it defaults in its loan obligation.\(^\text{220}\) Direct agreement between the project lenders and the parties of the commercial contracts (suppliers, purchasers and contractors) usually contains an undertaking from the party of the commercial contract not to exercise any right to terminate the contract under its default clauses, without first giving the project lenders a prior written notice. Further, it contains an agreement that, if the notice was given and the lenders in turn gave a counternotice, then the party of the commercial contract would either:

- allow the project lenders (or an agent appointed by them) to assume the project company’s rights and obligations under the contract for a specified period of time, or
- allow the transfer of the contract to a separate company (a new project company) established by the project lenders for this purpose.\(^\text{221}\)

The assignment of rights under the commercial agreements, in combination with the direct agreements, clearly represent the taking-over purpose of a security in the context of overall security arrangements in project financing.

7.6.5. Charge on the shares of the project company

As a part of the overall security arrangement, the shareholders may be asked to pledge their shares in the project company for the project lenders.\(^\text{222}\) Here, the purpose of the security interest is mainly to give the lenders the option of

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219 See Wood, Project Finance, Subordinated Debt and State Loans, 32; Vinter, 88.

220 Vinter, 88.

221 Vinter, 89.

222 Nevitt and Fabozzi, 52; Clifford Chance, 59; Wood, Project Finance, Subordinated Debt and State Loans, 30; Wood, Law and Practice of International Finance, 323; Vinter, 81.
taking over the project if it gets into difficulties.\textsuperscript{223} The pledging of the project company's shares seldom serves the realization purpose of security, since the shares hardly have much, if any, market value in case the project company is insolvent and cannot perform its contractual obligations. The security on the project company's shares is not taken, either, for defensive purposes, since it does not afford the project lenders any priority right on the project assets ahead of the project company's other creditors.

Whether the taking-over purpose of security can be achieved by pledging the project company's shares for the project lenders is dependent on the applicable security laws in the relevant jurisdiction. The taking-over purpose of security may be achieved if the applicable security law confers a right of possession to the pledgee. This would entitle the project lenders to assume the rights of the shareholders on a default under the project loan agreement, and replace the project company's management.\textsuperscript{224} However, in those jurisdictions where the only remedy to a pledgee of shares is judicial sale, the taking over purpose of security may be difficult to achieve. This is especially the case in those jurisdictions which have a rule against "self-dealing", \textit{i.e.} the secured lender selling the object of a security interest to himself or to a person connected with him.\textsuperscript{225}

\textsuperscript{223} Nevitt and Fabozzi, 52; Wood, Project Finance, Subordinated Debt and State Loans, 30; Vinter, 81 and 91.

\textsuperscript{224} Vinter, 81; Wood, Project Finance, Subordinated Debt and State Loans, 30.

\textsuperscript{225} Vinter, 81 and 91.
8. PROJECT LENDER'S RIGHT TO ACCELERATE THE LOAN

The riskiness of a lender's claim may be reduced if a lender is entitled to effectively demand for repayment as he sees fit when the financial standing of a debtor is becoming worse, thus jeopardizing the debt repayment. The lender should be most effectively protected if it had been agreed that the loan would be payable "on demand". Under this kind of repayment clause, the lender can call for repayment for any reason. In this case, no default clause in a loan agreement is needed. In project financing, loans payable on demand rarely constitute the core funding for a project, because they are not sufficiently committed. Loans acquiring the permanent operating assets of a project company, intended for long-term use, cannot be repaid as on-demand or unsecured short-term loans. Rather, it is necessary to repay the financing of these assets over time from the profits and cash flow generated by their use. Acquisition of machinery or equipment for a project company is meant to produce cash flow with which to repay the loan over a period of time. This arrangement contemplates a loan which must be repaid over a term of years. Project loans are typically term bank loans. Commercial banks have become sources of term loans, with maturities from two to ten years for project financing. Under a repayment clause, a project term loan may be payable in one lump sum ("bullet repayment") or in installments of fixed or variable amounts. The typical project term loan is repaid in installments, so as to match the projected revenue stream of a project. Such installments may be paid monthly, quarterly, semiannually, or even annually. The repayment schedule for the project term loan may include a recapture clause providing that, above an agreed base level, some percentage of earnings of cash flow will be annually applied as extra principal payment, in the inverse order of scheduled maturity. This practise protects the lender against profits dissipated prior to the scheduled

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227 Vinter, 52, supra note.
228 Nevitt and Fabozzi, 79.
229 Id. 80.
230 Vinter, 53.
231 Nevitt and Fabozzi, 80.
term loan payments.  

The general problem with a term loan for a lender is that, if the borrower goes into liquidation prior to the final maturity date and if the lender relies on the repayment clause alone, the lender might only be able to make a contingent proof in the liquidation, as the principal of his loan would not yet be due for repayment. This is unacceptable to the lenders. They should be entitled to accelerate the loan once they conclude that the debt repayment is in jeopardy.

Therefore, as in any other creditor-debtor relationship, one of the objectives of project lenders, in reducing their credit risk, is to have a large entitlement to accelerate a loan. The project lender’s right to accelerate a loan depends on how the events of default are determined in the project loan agreement. The overall purpose of a default clause is to specify the circumstances in which the lender can call for immediate repayment, (i.e. repayment before the maturity of a loan originally envisaged) of all sums outstanding.

Events of default may be divided into two main categories. The first category encompasses the breaches of the loan agreement itself, such as failure to pay sums when due, failure to comply with an undertaking or inaccuracy of warranty. The second category encompasses the anticipatory events of default. These are events making it probable that it is only a matter of time before the borrower actually is in default under a term of the agreement itself.

A default clause may specify even 20 or more events in which the lender can call for immediate repayment. However, the first event is invariably the same: the borrower’s failure to pay a particular sum (principal, interest, or any other amount) when due. For lenders, the event of non-payment is an implication that the borrower either can not or will not pay, or that he is prevented from paying. Therefore, in this situation lenders would be expected to terminate the loan and use whatever remedies are available to recover the money. In many cases, however, this is not the principal action to be considered by the project lenders, for reasons to be discussed below.

232 Id.

233 Vinter, 55.

234 Youard, 276.

235 Wood, Law and Practice of International Finance, 164.

236 Id. 277.
Altogether, events of default that typically can be found in project loan agreements include:237

1) non-payment
2) failure to achieve completion of a project by a long stop date;
3) destruction or damage to all parts or a substantial part of the project facilities;
4) cessation of production for a sustained period (for example, because of force majeure);
5) abandonment of the project by project sponsors;
6) nationalization of the project facilities;
7) a change in the law which adversely affects the project's economy;
8) non-availability of the required insurance cover;
9) failure by the sponsors to provide equity in accordance with the shareholders' agreement; and
10) breach of covenant (covenants typically included in the project loan agreements are discussed separately in chapter 9 below)

In addition to the events of default listed above, project loan agreements frequently contain events of default clauses related to "loan-to-value" cover ratios. There may be a clause under which the breach of a specified cover ratio constitutes an event of default.238 A cover ratio is a forecast of financial viability of a project re-determined on a running basis, e.g. every six months. The main cover ratio is a financial test comparing the estimated net present value of the project's future proceeds to the principal of the loan, in order to check that the loan will be covered by the revenues and hence be paid.239

Compared to an event of non-payment, all the other events of default are of an anticipatory nature in the sense that, once occured, they cast a serious doubt on the debtor's ability to pay lenders on the next occasion when a specific loan sum falls due. Moreover, these events of default imply that, at the time of future debt repayment, the chances of sufficient assets being available

237 Vinter, 78; Wood, Project Finance, Subordinated Debt and State Loans, 28.
238 Wood, Project Finance, Subordinated Debt and State Loans, 26; Vinter, 63.
239 Wood, Project Finance, Subordinated Debt and State Loans, 26. As to various types of cover ratios (the project life cover ratio, the loan life cover ratio, the drawdown cover ratio, the repayment cover ratio, the annual debt service cover ratio), see Vinter, 63-64.
to enable lenders to recover the outstanding debt by legal action is in jeopardy. Further, lenders are concerned about whether the other competing creditors may have seized all the assets liable for debt repayment. In this light, the essential meaning of events of default is to serve as an *early warning for the project lenders*.

Acceleration and enforcement is an absolutely last resort and only rarely to be viewed as a sensible means of protecting the project lenders' capital invested in the project company. The argument is that banks do not halt a project once their money is already in it, unless the situation is totally irredeemable. In project financing, the view of the banks is that events of default are not to be regarded as an opportunity to get one's money back, but rather as an ability to be heard in the management of the project company, if things should go wrong. If the lenders conclude that the loan is in jeopardy, this does not necessarily mean that an acceleration will take place. In the absence of sufficient assets enabling lenders to be paid in full (as it is often the case regarding the realization value of the project assets compared to the amounts of the project loans) it may be in the lenders' interest to continue in the operation. This, as a matter of fact, may involve re-negotiation (e.g. on re-structuring and re-scheduling) of the existing loans. Nevertheless, from the lenders' point of view, such a negotiation can only be effective if the lenders speak from a position of strength, i.e. with the ability to accelerate immediately if the re-negotiations are unsuccessful. In other words, the purpose of the events of default clauses is to *confer management control to the project lenders* in specified cases, and to *serve as monitoring devices conferring opportunities to renegotiate*.

In addition to the right of accelerating the project loan, other sanctions provided in the project loan agreement to confer negotiating strength on the occurrence of a default may include a draw-stop, i.e. allowing no further drawings of loan to a project company until the problem is solved. This sanction, however, can only be used during the pre-completion period, before the whole amount under the loan facility is drawn by the borrowing project company. The project lenders may also be permitted to freeze distributions to

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240 Youard, 277.


242 *Id.*

243 Youard, 278.
the project sponsors from the proceeds account of the project company (which should be controlled by project lenders). Finally, a compulsory build-up of retentions in the proceeds account may also be agreed upon.\footnote{Wood, Project Finance, Subordinated debt and State Loans, 28.}
9. PROJECT LENDERS' CONTRACTUAL CONTROL OVER OPERATIONS OF THE BORROWING PROJECT COMPANY AND PROJECT ASSETS

9.1. The controlling interest of project lenders

The riskiness of a creditor's claim is, in part, determined by the debtor's operations and actions with third parties. Thus, the credit risk may be reduced if the creditors have a right to supervise and control the debtor's activities and assets.

Overseeing the management and controlling the activities and business operations of a project company is primarily the right of the shareholders according to the company law under which the project company is established in the project's host country. However, it is also in the project lenders' interest to closely control the activities of the borrowing project company, thereby minimizing their risk. A project loan, the repayment of which depends upon the success of the project, should involve extensive controlling rights for the lenders since they assume many, or most, of the project risks with the equity shareholders. The project lenders' objective of controlling the project company can be achieved contractually by including various forms of covenants in the project loan agreement.

In broad terms, a covenant in loan agreement can be defined as *an undertaking in which the corporate borrower agrees to maintain specified economic and operational factors during the term of the loan.* Covenants bind the borrower in the conduct of its business during the period of commitment and for the duration of the loan. The essence of the covenant, as a contractual controlling and monitoring device, is that the breach of a covenant is frequently determined as an event of default in the loan agreement. The sanction of an event of default puts pressure on the management of the

245 Rapakko, 228.

246 See Wood, Law and Practice of International Finance, 144.


borrowing project company to comply with the provisions in the covenants. Moreover, the project lenders, by threatening to invoke the remedies if the breach of covenant has occurred, or is about to occur, can influence the management of the project company to make decisions beneficial for them.

Covenants can be divided into financial covenants and other covenants. In project financing, the financial covenants have the function of disciplining and directing the financial policies of the project company and its shareholders, thus protecting the interests of the lenders. The other covenants can be divided into affirmative covenants and protective or negative covenants. Affirmative covenants are promises made by the borrower to perform certain actions. The protective or negative covenants are designed to limit the actions and operations of the borrower. Both the financial covenants and the other covenants have the function of protecting the lenders, by determining and setting up certain limits to the transactions and operations of the project company.

9.2. The functions and objectives of various types of covenants

Certain financial covenants which have the function of preserving and testing the quantity of project assets and the project company's solvency, are frequently included in project loan agreements. Financial covenants include financial ratios which the project company is obliged to maintain. The debt equity ratio is one of the most typical financial covenants. It requires that during the term of the loan an agreed proportion, e.g., a ratio of 3:7 between equity and debt, has to be maintained. A high proportion of equity in the project company confers a better safety margin for the project lenders, thus protecting them in critical periods of the project. Financial covenants, like current ratio (the ratio of current assets to current liabilities) and minimum working capital (current assets less current liabilities) requirements, are also frequently used to preserve the solvency and to assure the liquidity of the

249 Harries, 356.
250 Nevitt and Fabozzi, 88.
251 Id. 89.
252 Id.
253 Harries, 357.
project company.\textsuperscript{254}

In addition to the financial covenants, there are various restrictive \textit{negative and protective covenants} which are used to preserve the asset quantity and solvency of the project company. They provide clear restrictions upon managerial decisions.\textsuperscript{255} These covenants may include:

1) \textit{Negative pledge and pari passu clause.} The function of a negative pledge, however, may be limited, since the project lenders often have security on all or most of the assets of the project company.\textsuperscript{256} The legal nature of a negative pledge and pari passu clause is discussed in chapter 7.2 above.

2) \textit{Restrictions on disposals of the project assets.}\textsuperscript{257} This restriction prevents \textit{e.g.} a sale of the project company’s key assets on credit to an associated company, so that the productive assets of the project company are converted into a claim on a possibly worthless company.\textsuperscript{258}

3) \textit{Restrictions on making loans.}\textsuperscript{259}

4) \textit{Restrictions on giving guarantees.}\textsuperscript{260}

5) \textit{Restrictions on borrowing.} The project company’s power to borrow or to give guarantees is frequently tied to the project and limited in amount.\textsuperscript{261}

6) \textit{Dividend and other distribution restrictions.} This restraint limits the amount of profits which the project company may distribute to its shareholders and restrains the depletion of its cash recourses. Restriction should also cover distributions in kind, such as reductions

\textsuperscript{254} \textit{Id}; Wood, International Loans, Bonds and Securities Regulation, 32.

\textsuperscript{255} Bradlow, 432.

\textsuperscript{256} Harries, 357.

\textsuperscript{257} Wood, Project Finance, Subordinated Debt and State Loans, 27.

\textsuperscript{258} \textit{See} Wood, International Loans, Bonds and Securities Regulation, 42.

\textsuperscript{259} Wood, Project Finance, Subordinated Debt ad State Loans, 27.

\textsuperscript{260} \textit{Id.} \textit{See} also Harries, 357.

\textsuperscript{261} \textit{Id.}
in capital.\textsuperscript{262} Dividend restrictions in project financing usually only allow distributions to the shareholders if the interests of the lenders are adequately protected, \textit{e.g.} through shareholder guarantees. \textit{7) Preserving the type of business activities.} Covenants in project loan agreements include restrictions on business activities of a project company. Normally, the business activities of the borrowing project company are limited to the construction and operation of the project.\textsuperscript{263}

For monitoring of the financial standing of the borrowing project company and the compliance of the terms of the project loan agreements, they frequently contain \textit{affirmative covenants} which obliges the project company to provide the financial information requested by the lender. This information may include \textit{e.g.} income statements and balance sheets, annual certification by an officer that the project company is not in violation of the agreement's covenants and the auditor's report. Moreover, a covenant may require that the borrower notify of defaults and of potential or actual litigation.\textsuperscript{264}

\textbf{9.3. Sanctions and remedies for breach of covenant}

Covenants in project loan agreements set up guidelines for the management of the borrowing project company in business decisions and transactions with the third parties. The threat of using the remedies for breach of covenant enables the project lenders to influence the management and interfere in the conduct of business of the project company. Breach of covenant frequently leads to negotiations between the lender and the borrower.\textsuperscript{265} Hence, it can be said that the covenants "give a contractual 'vote' to the project lenders in relation to the basic management of the project company."\textsuperscript{266} If the borrowing project company should make a transaction which contravenes the relevant covenant, then the management of the project company should ask for \textit{a consent} for this

\textsuperscript{262} Wood, Law and Practice of International Finance, 161.

\textsuperscript{263} Harries, 357; Wood, Project Finance, Subordinated Debt and State Loans, 27.

\textsuperscript{264} Wood, International Loans, Bonds and Securities Regulation, 32 -33 and 44; Nevitt and Fabozzi, 88.

\textsuperscript{265} Covenant working group report, 70.

\textsuperscript{266} Wood, Project Finance, Subordinated Debt and State Loans, 27.
transaction from the project lenders.  

There are several sanctions and remedies for breach of covenant. Under the project loan agreement, breach of covenant is an express event of default. Accordingly, the project lender is entitled to accelerate the loan. It also may be agreed that the repayment schedule of the loan is changed or the interest rate of the loan is increased, in case of breach of covenant. Depending on the applicable law in the relevant jurisdiction, the project lenders may also seek an injunction to restrain a threatened breach. This could be especially relevant for the negative pledge and restriction on disposals of the project assets. However, the project lenders should be able to take this action before the breach has occurred. Damages may also be available to the lenders for breach of contract.

267 See Covenant working group report, 71.
268 Wood, International Loans, Bonds and Securities Regulation, 33; Covenant working group, 70.
269 See Covenant working group report, 71.
271 Id.
10. CO-OPERATION AMONG PROJECT LENDERS AND INTER-CREDITOR AGREEMENTS

The financing of a major project often involves a number of various types of creditors of different types. The creditors of the project company may include e.g. commercial banks, project sponsors, lessors, and export credit agencies under separate credit agreements. The riskiness of a single creditor's claim is influenced by the competing creditors' rights and possible actions towards the debtor. When the financial health and the debt repayment ability of a debtor is becoming worse, creditors may try to do whatever they can to protect their position, and to obtain some advantage over other creditors. In project loan agreements the events of default clauses are especially strict, because of the effort by the lenders to keep control over the project. If an individual lender declares an event of default and accelerates its loan, this would set off a chain reaction with other lenders declaring similar defaults, under the cross-default clauses in their loan agreements, and taking actions to protect their collateral interests in the project. These kinds of actions by individual lenders may result in a harmful situation for all of them.

A single creditor's risk can be reduced if the creditors can agree, for their common interest, on the optimal actions in using their remedies against the debtor. In project financing, therefore, project lenders often enter into an inter-creditor agreement to regulate their relationships.

Typically, an intercreditor agreement provides that no lender is permitted to take legal actions alone, but only in accordance with this agreement. An intercreditor agreement contains provisions regulating majority rules and voting procedures for the exercise of the lenders' remedies. An intercreditor agreement usually covers issues concerning the following legal actions:

272 See e.g. Wood, Project Finance, Subordinated Debt and State Loans, 33.
273 See Nevitt and Fabozzi, 53.
274 Id.
275 Id.
276 Nevitt and Fabozzi, 53.
277 Harries, 359.
278 See Vinter, 107; Wood, Project Finance, Subordinated Debt and State Loans, 33; Harries, 359; Nevitt and Fabozzi, 53.
- waivers and consents to be given to the project company debtor,
- acceleration of the loans,
- enforcement of security, and
- approvals on suit, execution and insolvency petitions.

In addition, intercreditor agreements often contain a “pro rata sharing” provision, which provides for all the lenders to share in recoveries equally, or in a prescribed hierarchy, in an enforcement.\textsuperscript{279}

Ideally, an intercreditor agreement should be negotiated at an early stage in a project financing arrangement involving a number of creditors. Intercreditor agreements may become difficult to negotiate after it has become obvious that the project being financed has ended up in difficulties.\textsuperscript{280} There is also another reason for negotiating an intercreditor agreement at an early stage. Lenders’ remedies and legal actions against the project company debtor are not the only matters that should be coordinated. Coordination or harmonization is also needed for covenants, events of default, or other provisions of the separate loan agreements. For example, conflicting negative pledge clauses or conflicting financial covenants in separate loan agreements might lead the borrowing project company into an impossible situation.\textsuperscript{281} In order to avoid this, the lenders of the project company should reach common understanding concerning the contents of the loan agreements, before they are drafted and signed.

\textsuperscript{279} Vinter, 107; Wood, Project Finance, Subordinated Debt and State Loans, 33

\textsuperscript{280} See Nevitt and Fabozzi, 53.

\textsuperscript{281} Harries, 359.
11. CONCLUSIONS

In project financing arrangements, the nature of a contract as a planning instrument and as a risk allocation instrument is crucial. A basic premise for a project aiming at the creation of a new cash generating economic unit is a careful technical and financial planning. In the implementation of a project plan involving many participants being dependent on each other, there is a mutual need for ensuring that each of them will contribute the project by performing within the predetermined time-schedule and the standards of the plan (i.e. at a right time, in right place, and in right quality and quantity). The technical and financial plan of a project has to be documented also in form of contracts. These contracts define the rights and the obligations amongst the participants of the project plan, and they enable the participants to invoke the courts and executive authorities of the relevant jurisdiction for the enforcement of the contracts (and the plan). The contractual framework of a project financing arrangement involves all the important parties contributing the implementation of the project, i.e. the project sponsors, the project company, the project lenders, the project's host state or its governmental agencies, the contractors, the suppliers of equipment, energy, raw materials or manufactured goods, and the purchasers of a project's end product. In the context of project financing the nature of a contract as the implementation device of a technical and financial plan is emphasized.

Another characteristic feature of a contract in project financing arrangements is its role as a risk allocation instrument. A prudent technical and financial planning of a project should involve a clear, complete and realistic analysis of the project risks, combined with an effort to allocate the identified risks to the parties best able and most motivated to handle them. The allocation of risks can be achieved through the contractual network of the project, in which the project risks are distributed by establishing risk-related rights and obligations amongst the project's participants. The contracts determine who, and to what extent, will bear the risks and suffer the financial losses, if the technical and financial plan of a project does not work in practice as predicted. The risks present in practically every project include completion risks, operational risks and market risks. The completion risks are typically borne by the contractors under a construction contract and contractor's bonds, and by the project sponsors under a completion guarantee. Some of the risks of increased operational costs of the project may be allocated to be borne by the suppliers of energy, raw material or manufactured goods under the long term supply-or-pay contracts. The buyers of a project's end-product may bear the sales market
risk under the long term take-or-pay contracts.

The debt repayment in project financing is principally dependent on the sufficiency of the cash flow generated by the operation of a project. This is largely based on a successful implementation of the project which, in turn, is based on legally binding enforceable contracts. It is characteristics for project financing that, before the disbursement of a loan to a special purpose borrowing project company (charged with the construction and the operation of a project), the lenders generally require, as a condition precedent, all the contractual arrangements and material authorizations necessary for the construction, the operation, and the debt service of the project to be legally binding and enforceable. Normally, a carefully organized closing procedure should assure that all the participants in a project are legally bound to implement the project plan.

Focusing on the legal aspects from the project lenders' point of view, project financing is a combination of legal means and parallel contractual strategies aimed at achieving five essential credit risk minimization objectives, namely 1) an adequate external credit support and a recourse to the creditworthy third parties, 2) a priority right to the borrowing project company's assets ahead of other creditors, 3) a large entitlement to accelerate the loan, 4) a control over the operations, the assets, and the transactions of the borrowing project company, and 5) co-operation amongst the creditors for the elimination of an adverse exercise of legal remedies by competing creditors. The degree of achieving these objectives in contract negotiations depends on the parties' interests, their bargaining power, skills and experience.

Each of the parallel contractual strategies for the lenders protection is important as a part of a whole. A lack of achieving one of the credit risk minimization objectives increases, to some extent, the need to compensate it by achieving a higher degree of another objective. For example, if the realization value of the project assets is low, a higher degree of external credit support may be needed from creditworthy third parties. Further, a higher degree of credit risk due to the lack of recourse to the third parties and/or the lack of priority right to the borrowing project company's assets may, at least partly, be compensated with an extensive contractual control over the operations, the assets, and the transactions of a project company by including various covenants to the project loan agreement. Moreover, if a single project lender can not, ahead of other creditors, acquire a priority right for his claim against the project assets, his position as a risk-taker is improved, if it can agree with the other creditors on the exercise of legal remedies against the borrowing project company. Generally, achieving inadequately one credit risk
minimization objective increases the importance of achieving other objectives.

Each of the contractual means of achieving credit risk minimization objectives involves some inherent, direct or indirect costs which may be substantial. The costs of various credit risk minimization techniques are ultimately borne by the project company and the shareholders. On the other hand, a higher degree of achieving risk minimization objectives should, to a certain extent, decrease the interest rate required by the project lenders as a compensation for the riskiness of their claim against the borrowing project company. A comparative research concerning the cost-effectiveness of various credit risk minimization techniques of project financing would be an important and interesting subject for a separate study.

The project lenders' objective to have the credit sufficiently supported under the contracts and guarantees, which provide them an adequate recourse vis a vis the creditworthy third parties, can be regarded as a primary contractual risk minimization strategy in project financing. Like Nevitt and Fabozzi in their book "Project Financing" put it, "the key to a successful project financing is structuring the financing of a project with as little recourse as possible to the sponsor while at the same time providing sufficient credit support through guarantees or undertakings of a sponsor or third party, so that the lenders will be satisfied with the credit risk". In project financing, by definition, the lender principally looks to the cash flows of the project as the source of funds for repayment, and to the assets of the project as collateral for the loan. Completely non-recourse financings, in which the lenders exclusively look to the cash flow and the assets of the project, are rare. Typically, project financing falls in the category of limited recourse financing, in which the project lenders are provided with some form of external credit support from the third parties, predefined and limited in the financing documents.

The external credit support may take several forms providing the lenders direct or indirect recourse to the third parties. It may be based on direct dept repayment securing undertakings constituting an obligation to pay directly to the project lenders (e.g. deficiency guarantee, contingent guarantee, loan purchase agreement, repurchase agreement). The external credit support may also be based on support agreements (e.g. investment agreements and commercial support agreements like take-or-pay contracts, exclusive supply agreements, and supply-or-pay contracts) constituting to a third party an obligation to pay or to perform to the project company, thus indirectly supporting its dept repayment capability (indirect dept repayment securing undertakings). Moreover, the project company's rights under the support agreements may be assigned to the project lenders.
The project lenders' priority right to project assets can be maximally achieved by establishing security interests on all the project assets, as far as this is possible under the laws of the country where the assets are located. Unlike in conventional secured lending, in project financing the primary purpose of a security is not necessarily to enable the lender to sell the asset in an event of default. In many cases, the purpose of security is mainly defensive, i.e. to prevent other creditors from acquiring property rights in priority to the project lenders, thus aiming at eliminating possible disruptive actions against the project company. Moreover, in project financing the purpose of security arrangements may be to enable the lenders to take over the project and to sell it as a going concern. Finally, arrangements involving assignment of export proceeds by way of security, and the use of foreign escrow accounts to receive those proceeds, may serve the purpose of insulating political risks.

In order to reduce the credit risk, the lenders should be able to get back their loan investment, if the prospects for the dept repayment are endangered in the future. Accordingly, one of the credit risk minimization objectives for the project lenders is to have a large entitlement to accelerate the loan. This can be accomplished by including into the project loan agreement various events of defaults, specifying the circumstances in which the project lenders can call for repayment of the loan. The project loans are advanced to the borrowing project company for the purpose of construction of project facilities and the acquisition of the assets, e.g. machinery and equipment meant for producing the cash flow with which to repay the loan over a term of years. In case the borrowing project company is in default, and the realization value of the project assets and the guarantees given to the project lenders do not cover the outstanding loan amounts, it may be in the project lenders' interest not to call for immediate repayment. Obviously, the acceleration might cause the liquidation of the project company and thereby close down the cash flow producing operation of the project. Therefore, it may be in the project lenders' interest to allow the project company to continue the operation. In this situation, a large entitlement to accelerate the project loan is primarily a contractual method for conferring the project lenders a strong position to negotiate on re-structuring and re-scheduling of the loan, and to influence the project company's management and operations. Here, the right to accelerate serves the same function as covenants in the project loan agreement. Breach of covenants frequently constitutes an event of default.

_The covenants permit the lenders to control and to influence the future conduct of the borrower in a manner that will reduce the risk that the loan will not be repaid._ Generally, the need for policy and business controls increases
according to the degree of the risk undertaken by the lender. A project loan, the return of which depends upon the success of the project, should be supported by extensive contractual controls since the project lenders, initially, assume the same risks as the shareholders of the borrowing project company. The covenants bind the borrower in the conduct of its business during the period of the commitment and for the duration of the loan, and, in the case of negative (restrictive) covenants, provide clear restrictions upon managerial decisions. The covenants accomplish the objective of controlling the borrowing project company's operations, assets, and transactions with the third parties in several ways: e.g. by preventing the borrower from preferring other creditors (the negative pledge), by restricting excessive leveraging (restrictions on debts), by preserving and testing the quantity of assets in the borrowing company (restrictions on dividends and financial ratios). In devising financial covenants for the foreign project company, the lenders should take into account the foreign accounting principles applicable to the borrower. The covenants frequently include an agreement on the borrower supplying financial and other information, so that the lender can monitor the condition of the borrower and take the most reasonable corrective action as early as possible. Breach of covenant serves as a warning signal of difficulties. If a violation of covenant is necessary for conducting the business of a project company, a waiver for this should be asked from the project lenders. In other cases the breach of covenant should provide a wide range of possible reaction alternatives to the project lender, including re-negotiations on the terms of the loan, requirement of additional guarantees from the project sponsors or charges to project assets, refusal to make additional loan advances, and acceleration of the loan.

However, if all the creditors of the borrowing project company have entered into an inter-creditor agreement, no lender is permitted to take legal actions individually under its separate loan agreement. An inter-creditor agreement serves the credit risk minimization objective of eliminating the possible adverse exercise of legal remedies by individual lenders. It typically contains provisions on voting procedures concerning legal actions like acceleration of the loans, enforcement of security, and approvals on suit, execution and insolvency petitions.

The use of several contractual strategies for the lenders' protection often makes the contractual network of a project financing very complex. In addition, there may be many applicable national laws involved, since parties of an international project financing arrangement are in many instances free to choose the most expedient law for governing their contractual relationship. However, the success of a project is very much dependent on the legal
framework of the project's host country. To be feasible, both the project and the project financing require a rather well developed legal infrastructure, based on individual property rights, free contracting and generally a legal system akin to western standards. Despite of its complexity, project financing has proved to be an increasingly appealing method for financing economic development, especially in the Central and Eastern European countries as well as in South-East Asia. This fact is primarily based on the continuing requirements for infrastructure development combined with privatization. In recent years project financing has experienced a boom in demand.