COMMENTARY ON PROJECT SECURITIES

By Frank J. Conroy*

John Lehane has canvassed several problems relating to project securities. The focus of this comentary will be on three of the problems discussed

1. floating charges;
2. assignment of sales contracts; and
3. cross defaults.

The first needs close attention because it permits the bankers' view on the importance of taking security over project assets to be presented in perspective; the second and third because recent resource-related project financings in Australia in which Westpac has been involved provide good examples of the difficulties bankers encounter in their attemps to instruct legal advisers to take and perfect security over all relevant project assets.

In addition, there is a need to be clear what is meant by project financing. The textbook definition states

> A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.[1]

Cash flow generated by the project is all-important. As a fundamental principle, bankers do not like lending to a project where they expect to have to exercise their rights under the security and sell the secured assets to collect their loan.

The degree of recourse to the project sponsor is always subject to negotiation from the outset. Sponsors seek to minimize the recourse to their own balance sheets as far as practicable. To the extent this is possible depends largely on the bankers' assessment of the risks which attach to the project. These risks are usually classified as to completion, adequacy of resources, operating, market, currency and political.[2]

Recent resource-related project financings in Australia have seen a marked movement away from reasonable risk sharing between sponsors and bankers. A clear example of the shift in risk sharing is in the completion risk. There have been projects financed over the past two years which have ranged from the position where the full risk is taken by the sponsor by providing a debt and interest guarantee until a defined completion date, which allows the bankers a right to take action under the guarantee to force the sponsor to subscribe sufficient monies to complete the project, to a watered-down performance undertaking which only provides the bankers with the right of action against the sponsor for specific performance of its obligation to ensure completion of the project, to the provision of no completion guarantee or undertaking by the sponsor where the entire risk of completion rests at the feet of the bankers.

*B.Comm., M.B.A., A.A.I.B. (Snr.), A.F.A.I.M., Chief Manager, Corporate Banking Division, Westpac Banking Corporation.

1 Nevitt P.K., *Project Financing* (1980) 1.
2 Wood P.R., *Law and Practice of International Finance* (1980) 313.

Project financing, therefore, is all about risk sharing which in traditional lending is usually left to equity holders and not bankers.

FLOATING CHARGES

Since bankers are asked to take increasing share of the project risks, it is little wonder that their approach to the form of project securities taken is almost at the stage of paranoia. Sponsors usually want to isolate the project from the remainder of their activities. This is a principal reason sponsors resort to this form of financing. They want to place a fence around the project and its assets and the cash flow generated by those assets. This concept of isolating the project is understood and accepted by bankers. Because of the nature of the risk sharing, in theory, everything which resides inside the area surrounded by the fence should be capable of being secured in one form or other.

Wood expresses the issue more clearly by describing project security as primarily negative and defensive, 'a shield rather than a sword'.[3] The security is taken by bankers to prevent other creditors of the sponsor (or the project itself) from being placed in a more advantaged position than that of the project bankers and also to strengthen their negotiation position with the sponsor. Lehane's paper highlights several weaknesses of project securities, particularly the question of whether such security should be floating or fixed.

From the bankers' perspective, the position is clear. If the balance of risk taking has moved substantially towards the bankers, it is only reasonable that they be provided with the opportunity to have an increased share of the decisions on how the project is managed. This is not to say that bankers wish to interfere with the day to day prerogative of project management. The necessity to take a floating charge is reasonable to allow the day-to-day trading activities to proceed without frustration from the bankers. It is unreasonable, however, for the bankers to be placed in a position where all or part of the security is floating where the risk of an execution being levied is always present. To place the bankers in this position is simply leaving the gate open to an area over which it was agreed with the sponsor that the bankers would have absolute priority in return for taking a greater share of the project risks.

Furthermore, sponsors have the tendency to change character when things go wrong either within their company or with the project, and will always seek to protect their own interests even if it means breaking down the fence to do so.

Lehane's paper highlights the solution to overcome some of the inherent problems of the floating charge. These include prohibiting the creation of further encumbrances, incorporating an automatic crystallization clause and identifying specific assets over which a fixed charge can be taken. The incorporation of an automatic crystallization clause seems to provide a degree of protection needed by bankers. The question is: is there sufficient case law available to place the position beyond doubt? Bankers should have the right to seek the strongest possible position with regard to priority of the security over assets. Sponsors which instruct their legal advisers to resist the inclusion of the solutions to the problems of a floating charge do not display a reasonable awareness of the imbalance of project risk taking by their bankers.

3 *Ibid.* 323.

One further matter needs comment on charges over project assets generally. There has been a trend over recent years for sponsors to embark on imaginative and sometimes questionable schemes to minimize the impact of various State duties. While there is no reason for bankers to object to sponsors attempting to reduce costs, it is of concern when the schemes result in reducing the effect of the security over the project assets.

There have been examples in the past when bankers have been placed in an intolerable position when faced with the decision of either insisting on perfect security being taken or allowing the sponsor to relax some of the front-end costs of the project in the form of State duties. Again, the fence surrounding the project is being violated. Advice provided to sponsors of this type often ignores the additional costs incurred by the legal advisers of both sponsors and bankers (which may include reference to Queen's Counsel's opinion), the additional time taken on both sides while the legal advisers sort out the issues, the difficulties experienced by the bankers' legal adviser when explaining the issues to members of the banking syndicate who are often resident overseas and, finally, that the agreed solution may be dubious as to its legal efficacy should it be tested in future years.

ASSIGNMENT OF SALES CONTRACTS

To be consistent, if bankers argue that the fence surrounding the project is not to be violated, then contracts relating to the sale of the product of the project should be capable of being assigned in favour of the bankers. Like the floating charge problem, for the bankers to be inflexible in this area would not attune to commercial reality.

In a recent large resource-related project financing, the commercial reality was presented to the bankers rather forcefully. The bankers were faced with the problem that some of the overseas buyers of the project product refused to consent to an assignment over the sales contracts. Since the bankers had obtained their credit approval on the basis that an assignment over the sales contracts would be available as part of the security package and to avoid any delay in the closing of the financing, it was necessary to look for an equivalent security to protect the bankers.

The solution was agreed by formalizing the charge over the proceeds of the sales contracts. The proceeds of the sales contracts flowed to the project by two separate methods; first, by telegraphic transfer of the payments to a nominated charged bank account of the sponsor at the bankers' Australian agent; the second provided for letter of credit payments to the sponsor's nominated charged bank account at an Australian bank and irrevocable instructions were held for the proceeds to be transferred to the bankers' Australian agent. The bankers were advised that they would have a valid charge on the proceeds of the contracts once they were paid into the charged accounts. In order to mitigate the risk that funds might be diverted or attached prior to arriving at the respective bank accounts, the sponsor agreed to include as an event of default the attachment of uncharged proceeds of a sales agreement which had not been remedied within ten days by either lifting the attachment, or by the sponsor depositing the relevant amount.

Because the sponsor was prepared to absorb recourse should the proceeds go astray, the bankers were left with benefits substantially comparable to those originally sought in the form of an assignment over the sales contracts.

One interesting aspect was the question of what would happen in the case where there was an event of default, a receiver was appointed by the bankers, and

the sponsor itself was separately placed in liquidation. In those circumstances, the bankers were advised that without the benefit of an assignment over the sales contracts, the receiver might not be entitled to the benefit of the sales contracts. The receiver would, however, have possession of the product and would be in a position to ensure that the product was not delivered unless satisfactory arrangements were made for payments to flow directly to the receiver.

Lehane has comprehensively covered the difficulties of assignments over sales contracts. He recognizes but questions the need for bankers to enter into complex arrangements involving the destination of the sales proceeds. Not to create solutions of the kind outlined in the example above would fail to address the problem which bankers face when lending against project cash flow. The integrity of the cash flow must be preserved; otherwise, bankers lose control over the very source of their repayment.

CROSS DEFAULTS

Lehane has drawn attention to the problems of cross default provisions in relation to limited recourse financing. Sponsors seek to ensure their project financing bankers themselves do not violate the fence around the project by joining in with bankers of other loans of the sponsor and try to obtain corporate recourse. Lehane correctly points out that where such cross default is possible, the nature of limited recourse to a large extent is illusory.

Recent resource-related project financings in Australia have produced three different approaches to this problem. The first ('Example A') was resolved by renaming certain of the events of default as 'Special Prepayment Events'. In this example, such events included failure to pay within a certain period, failure to observe obligations under particular covenants and the removal of governmental approvals. Should a Special Prepayment Event occur, the sponsor had the right to offer to convey the project to the bankers. The conveyance had to be such that the project assets were free of any other encumbrance. Once the offer had been made and the bankers did not accept the offer, the sponsor need do no more. At the end of six months, the debt would be eliminated. Clearly, the bankers are not in any position but to accept the offer of conveyance. Note that in this example, there is no provision to appoint a receiver.

In the second approach ('Example B'), certain of the events of default were renamed Special Prepayment Events on similar lines to Example A. These included failure to pay, removal of governmental approvals, failure to achieve completion and failure to perform obligations under a specific sales agreement of the project product. Should a Special Prepayment Event occur, the bankers had the right to call up the loan but not appoint a receiver. The bankers then had the right, if they so chose, to make request to the sponsor as to the way it disposed of the project assets. In other words, the sponsor would act in the same manner as a receiver. Should the sponsor not comply with the request of the bankers, such non-compliance would be regarded as an event of default. Costs of keeping the project alive, and the liabilities incurred during this 'self-receivership', would be the responsibility of the bankers.

The third approach ('Example C') had some similarity to Example B. Special Prepayment Events were much the same except that failure to pay remained an event of default. Should a Special Prepayment Event occur, the loan could be called up as in Example B with no appointment of a receiver. The sponsor could pay up or offer conveyance of the project free of encumbrance. In this example, however, the

bankers insisted that there be an order obtained from the Supreme Court to the effect that the conveyance to the bankers would take effect free of any right of the sponsor to redeem the project assets. Should the bankers accept the conveyance, the debt would be eliminated. The bankers had the option to request 'self-receivership' as in Example B. If the sponsor did not repay the loan or offer conveyance and the lenders chose not to request 'self-receivership', then after six months, there would be an event of default with the normal right of the bankers to appoint a receiver.

It is interesting to note that in Example C, the bankers can move to request 'self-receivership' to stop the sponsor from conveying the project to them. This is a much improved position for the bankers than Example A and is far more favourable than Example B, as a failure to pay remains as an event of default.

The three examples were resolved between the sponsors and bankers in the same chronological order. The examples provide some evidence of a hardening of the attitude of bankers to any attempt by sponsors to reduce the effect of the security. Westpac refused to participate in the project described as Example A on the fundamental principle that the bankers had no right to appoint a receiver. This right has been available to all forms of lending in the Australian market since its history began and the Bank saw no compelling reason to put it aside.

Lehane has commented in his paper that solutions of this kind to the cross default problem are complex, may involve doubtful questions of law and are rarely effective. They certainly do not appeal to bankers and again tend to violate the fence. Sponsors, aggressively encouraged by non-Australian financial advisers, are taking the unreasonable stand on insisting that project bankers weaken their security to avoid approaching corporate loan bankers to seek amendment to existing loan agreements.