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Project Finance: Issues for Project Sponsors and Project Contract Counterparties

Peter J Doyle*

SUMMARY

This paper examines aspects of project financing of particular relevance to sponsors considering the development of new (so called "greenfield") projects in the mineral, petroleum, petrochemical or energy industries. Aspects of project finance to be given particular attention are: (a) Project bankability issues and risk factors such as source and firmness of supply, quantum, pricing, default and termination, force majeure and financial obligations (such as liquidated damages); (b) Financing plan including key issues negative pledge restrictions, project finance covenants, project cash flow access, completion tests, the choice of project vehicle, funds contribution, financiers' security, credit ratings and market flex clauses; (c) Management of special risk including process and design risk, WTO compliance for government support, project insurance requirements and the risk associated with terrorism, selling offtake, multi-user infrastructure corridors and tax risk; (d) Consent deeds – the purpose of these documents and how project contract counterparties can ensure their rights are protected.

WHAT IS PROJECT FINANCING?

Before looking at the aspects of project financing, it is helpful to understand the essence of project financing. Two conventional definitions of project financing, by respected commentators, provide a good starting point.

Project financing is:

> "financing the development or exploitation of a right, natural resource or other asset where the bulk of the financing is not to be provided by any form of share capital and is to be repaid principally out of revenues produced by the project in question."[1]

* LLM (Melb), BCom (Melb); Partner, Mallesons Stephen Jaques, Solicitors, Sydney.

[1] G Vinter, *Project Finance* (2nd ed, Sweet & Maxwell, London, 1995), p XXVII.

> "a financing of a particular economic unit in which a financier 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 a loan."[2]

Ignoring the minor differences in substance and emphasis between the two definitions, both show that in project financing, financiers look essentially to the cash flows of a single asset (the project) for repayment.

This can be contrasted with a corporate style financing where financiers look to the overall strength of a company's balance sheet, which is usually derived not from a single asset but a range of assets and businesses. Even in a project financing, however, some additional assistance may be required from project sponsors or other stakeholders through equity contributions or other forms of support, particularly during the construction phase of the project.

It is an essential element of any project financing that the financier's recourse is primarily limited to the project revenues and assets. This is often referred to as limited recourse financing. Generally, this is achieved either by creating a special purpose vehicle as the borrower which has no assets other than the project, or by confining the financier's security to the project assets (ie, the personal liability of the borrower is either excluded entirely or confined to the amount actually recovered from the project assets and cash flows). Any failure or unavailability of those assets and cash flows will affect the financier's ability to be repaid.

PROJECT BANKABILITY

Project bankability is the phrase which is used to describe the process of assessment by the sponsor and particularly by financiers of whether the project is capable of supporting project financing – that is whether, having regard to the project's forecast cash flows and the risks attaching to the project, financiers will lend against the project on a limited recourse basis.

This process of assessment involves the financiers in a detailed analysis of the risks associated with the project. Of course, any financing involves an analysis of risk by the financier. What differentiates project financing from other forms of financing is that, in a project financing, the financier is trying to create, to the maximum extent possible, a "closed circuit" of risk – that is, to identify all of the risks that bear upon the project, analyse those risks, allocate those risks between identifiable parties and put in place a detailed mechanism to manage the risks. This process of detailed identification, analysis, allocation, and management of risks associated with any project is fundamental and is one of the defining features of project financing.

This analysis of risk is not unique to the financier and its lawyers. Each of the project sponsors (ie, the persons who are the ultimate owners of the project), the

[2] P Nevitt, *Project Financing* (4th ed, Euromoney Publications, 1983), p 3.

project vehicle (ie, the company or other entity through which the project sponsors hold the project) and the financiers, for their own reasons, need to be satisfied that all relevant risks have been identified, quantified, and appropriately allocated. In a large project financing, the list of stakeholders with an interest in the management of risk may also include government and regulatory bodies, construction contractors, project suppliers, purchasers of product (ie, offtakers) and insurers.

The process of determining project bankability through a detailed risk assessment process typically commences at the very beginning of the project. In a resources project, for example, identification of risks is often carried out through the project sponsor's feasibility study for the project. In an infrastructure project, there is usually no feasibility study, however, there will be an analysis of project risks undertaken by the sponsor and a strategy developed to manage each of those risks (eg regulatory, environmental, native title and construction). Sponsors may engage independent third party consultants to assist them in analysing relevant risks. The financiers will usually base their analysis of the project on the sponsor's risk analysis but will often supplement that study with their own analysis and that of specialist consultants. For example, reports are often required from consultants in relation to market risk, technology risk, environmental risk and insurance risk. In addition, financiers will often require an audit of the financial model and opinions on tax and accounting matters.

The process of risk identification and allocation shapes the overall structure of the financing and identifies the issues which require special consideration by the financiers. Through this process of risk identification and analysis, the financiers will reach a view as to whether the project is bankable. Among other things, this will involve the financiers satisfying themselves that:

- the nature and extent of each risk has been identified and those risks are acceptable;
- the allocation of risks between interested parties is appropriate and those parties are capable of bearing those risks;
- the legal structure through which the project is held by the sponsors and any other project participant will be appropriate; and
- the funding medium by which the financiers are to provide funds is appropriate.

It is difficult to generalise about the risks applicable to project financings. While certain risks are universal, such as political risk and operational risk, different types of project have their own special kinds of risk. For example, an oil or gas pipeline has a substantial competition law risk which is not found with most other financings.[3] Even if the risk is a universal one, meaningful analysis of the nature of the risk will depend on the particular industry; for example, the market risk for a hotel development, power station or mineral project is each very

[3] S O'Rourke, "Pipelines: Structuring New Projects" [1995] AMPLA Yearbook 279 at 285.

different. Finally, the individual circumstances of the particular project and its sponsor and other participants and the risk appetite of the financier (or more specifically its credit committee) will significantly affect the nature and extent of the project risk and therefore project bankability.

Bankability Issues in Regard to Gas and Electricity Supply Contracts

Gas and electricity supply contracts can be of critical importance when considering the bankability of projects such as light metals projects and petrochemical projects.

As a general comment, financiers will review such contracts carefully to ensure that:

- the supply contract will be available for the life of the project (or at least the term of the debt);
- the contract will be available upon enforcement of the security and can be transferred to a purchaser of the project;
- the contract does not impose unreasonable or financially onerous obligations upon the project vehicle; and
- the contract recognises that the financiers will seek cure rights in respect of defaults by the project vehicle.

In the case of a gas sale and purchase agreements, some of the key factors which both sponsors and financiers need to consider include:

(a) the firmness of the obligation to supply gas and the circumstances in which that obligation is excused;

(b) the source of gas supply and the life of the underlying reserve (ie, are there sufficient reserves to meet the contracted amount over the life of the contract);

(c) restrictions on the ability of the gas supplier to supply third parties where this could impact the availability of gas to supply the project vehicle;

(d) the quantum of gas to be supplied particularly the impact of any "take or pay" obligation or minimum and maximum quantity specifications and daily and hourly maxima – if there is a maximum quantity specified, is there a mechanism for additional gas to be purchased by the project vehicle (ie, in the event of improved plant efficiency or plant expansion). Related issues are the impact of force majeure on any "take or pay" or minimum purchase obligation (ie, is any relief from the obligation to take gas available to the project vehicle where it is affected by force majeure) and the ability of the project vehicle to source alternate gas if the supplier fails to supply and be reimbursed for its costs in that regard. Consideration also needs to be given to gas banking. Gas banking is the ability of the buyer to take gas which has been paid for under the "take" or "pay" at a later time for free – this concept

gives financiers comfort that there will be a cheap source of gas when the project is recovering;

(e) the measurement regime (ie, metering and any fallback measure if metering is not operational) and the regime for testing the equipment;

(f) the standard of gas to be supplied and the consequences of supply of off-specification gas (particularly if the plant is likely to be adversely affected);

(g) the timing and firmness of availability of gas supply (particularly during plant testing and commissioning);

(h) the pricing for gas supplied and any regime for price escalation (and/or review, particularly linkages to the offtake commodity price in the escalation formula);

(i) the responsibility for transportation of the gas to the point of supply;

(j) the liquidated damages regime where there is a failure to supply gas;

(k) relief for force majeure affecting either the gas supplier, the pipeline operator or the project vehicle and the right to terminate where there is an extended force majeure;

(l) termination events (particularly cure periods) and any indemnities;

(m) the obligations of the gas supplier to obtain and maintain all necessary consents and approvals;

(n) restriction on the ability of the gas supplier to assign its rights; and

(o) any options to extend the initial term of the supply contract.

In addition, financiers will be concerned to ensure that the gas supply contract provides that the project vehicle can grant security over its rights under the contract and that the gas supplier will enter into a consent deed with the financiers. Sponsors should bear these matters in mind when negotiating the gas supply contract and ensure that such provisions are inserted so as to avoid arguments at a later stage after financiers have been appointed.

Electricity supply contracts raise a number of similar issues (apart from the concept of gas banking which is not feasible with electricity). As with gas supply contracts, it is often the case that an electricity supply contract needs to be negotiated by the project sponsor in advance of the financing arrangements for the project. As a result, the contract may need to deal with a number of potential future events, the occurrence of which is uncertain.

Issues which need to be considered from both a sponsor and bankability perspective are as follows:

1. Certain types of plant may be able to have power supply interrupted during operation without damage being caused. Such interruptibility rights can have substantial value to a generator in the National Electricity Market (NEM) and can lead to a lower overall power price being negotiated by the project sponsor. The reason why these rights are valuable are that during periods of shortage of supply, the generator can reduce power supply to the project and sell power in the spot market and take advantage of high spot prices. The seller will usually seek to restrict the project entity from otherwise contracting the interruptibility features of the plant or using those characteristics to otherwise derive revenue in the electricity market.

If there are interruptibility rights granted, the project entity will be obliged to give undertakings as to the development of the plant in a manner which allows the power supplier to exercise its interruption rights and also to be present during testing of the plant. The power supplier will usually want the ability to install its remote interruption facilities at the plant so that interruption can occur instantaneously by the supplier sending a signal to the remote interruption facilities. Restarting of supply to the plant should be a matter under the control of the project sponsor so as to ensure that the plant is not damaged.

2. As with gas contracts, usually power will need to be supplied during the commissioning period of the plant. The project sponsor needs to ensure that there is some degree of flexibility as to when this period starts and finishes as there may be delays in construction. Usually different pricing regimes will apply for the commissioning period and the commercial operation period. Invariably the supplier will require that there be a "drop dead" date for commencement of plant operation – the project entity needs to ensure that it has a right to extend the commercial operation date by up to the latest likely time that could result from a delay during construction. The supplier will want a right to terminate the contract if the plant is not operating by this date.

3. Except in Western Australia and the Northern Territory, connection of the plant to the power supply will usually be done under arrangements with a network services provider (NSP). The power supplier will usually require that the project vehicle and the NSP enter into a tripartite deed which gives the supplier the ability to cause the power supply to the project to be disconnected. The project entity needs to ensure that disconnection notices can only be given in very limited circumstances (such as failure to pay invoiced amounts, insolvency events, failure to provide any agreed credit support or termination of the supply contract) and that even after such notice is given the supplier will direct the NSP to reconnect if the relevant default is cured.

4. The power supplier may reserve the right to increase the negotiated price if certain events occur or fail to occur by certain dates. The project vehicle should reserve the right to either accept or reject the varied price.

5. The supplier will usually require that there be a limit on demand ("contract maximum demand" or "CMD") according to the requirements of the plant. The project entity should ensure that it has an ability to take an agreed number of MW above the CMD on a temporary basis so as to ensure operational flexibility. If there is a minimum amount of power which is required to keep the plant from shutting down completely, this must be specified in the contract – this is often referred to as the "must run load" and cannot be interrupted. If there is an interruptible load and a must run load, this will require separate metering at the plant (ie, the must run load cannot be interrupted at all so it must be supplied through a separate meter).

6. The project entity should also ensure that it has the ability to purchase additional power from other suppliers. The supplier may require matching

rights (ie, the right to match terms of supply offered by third party suppliers) but the project entity should ensure that there is no matching right unless the supplier is one of the most competitive in any tender process for additional power. Power from a third party supplier will need to be separately metered.

7. The supplier will often be concerned to protect its financial exposure to the project entity in respect of excess energy (ie, energy taken above CMD). The reason for this is that such energy will be at spot prices rather than at the contract price. If spot prices are high, then the price for excess energy could be a significant amount over a short period. The seller will usually want the ability to give short notice to the project entity to cease taking excess energy where it is of the view that spot prices will be high and likely to interrupt supply. The project vehicle should not be liable for a breach of the agreement by simply taking excess energy before receiving notice from the seller or otherwise prior to interruption. The supplier may also wish to specify the loss it will suffer (such as loss of profits or revenue) if excess energy is taken when not permitted. The supplier may also require excess energy charges to be paid within a shorter period than the normal payment terms under the contract.

8. Depending on the nature of the plant, there may be opportunity for additional revenue to be derived through the supply of ancillary services (being either frequency control ancillary services or network control ancillary services). The project vehicle should not readily agree to give up these potentially valuable rights to the supplier.

9. From a sponsor perspective, it is sensible to negotiate liability caps to apply in circumstances where there is either a breach of the agreement or termination of the agreement due to a failure or default by the project entity. As elements of loss by a party may be consequential, these losses should be identified in the contract. In the case of the supplier, such loss may include unwinding of hedge positions, loss of revenue over the contract term and loss of profit flowing from loss of interruption rights. In the case of the project vehicle, loss may include loss or profit or revenue due to an inability to operate the plant, liability to third parties as a result of a failure to operate the plant and costs in purchasing electricity from other sources.

10. The contract should specify what is to happen if there are changes in government imposts or changes in law which affect costs after the date of the contract – the supplier will wish to pass these through to the project vehicle but the supplier should also be required to pass through to the project vehicle any savings. The supplier should be required to allocate such additional imposts amongst its customers on an equitable basis. If the supplier can reduce its liability for additional government charges by acquiring a certificate, permit or licence or entering into transactions with third parties, it should be required to do so. The supplier should not be permitted to pass through additional charges imposed on it as a generator. Flow on charges (such as National Electricity Market Management Company (NEMMCO) and

National Electricity Code Administrator (NECA) fees) will usually also be passed through to the project vehicle by the supplier.

11. Relief for force majeure events should be included in the contract for the benefit of both parties.
12. If the supplier controls generating plant, the project vehicle may wish to prescribe what is to happen if the supplier ceases to own or control that plant. In particular, the supplier should be required to deliver a tripartite deed whereby another generator, subject to obtaining any licences, agrees to take over the contract.
13. The supplier may require credit support to be provided in certain circumstances (such as by way of bank guarantee). The project vehicle should ensure that the need for such support falls away if the project vehicle obtains an investment grade credit rating.
14. Finally, the supplier may seek to include a clause allowing for the contract to be adjusted for future changes in the NEM or electricity legislation. The project vehicle should ensure that it has the ability to refer any proposed amendments to an independent arbitrator for resolution if the parties cannot agree on the form of the proposed changes.

FINANCING PLAN

At an early stage in the planning of the development of a new project, consideration needs to be given to the financing plan.

The issues which need to be considered include:

- whether the project is to be financed through the sponsor's internal financial resources or project financed;
- any restrictions to which the sponsor is subject which may limit the flexibility of any project financing arrangements (such as a sponsor negative pledge);
- the impact of project financing covenants on the sponsor's flexibility to run its business (ie, cash flow lock up and cash sweep in particular) and on the sponsor's own credit worthiness (ie, particularly if the sponsor itself holds a credit rating);
- the nature of the project vehicle;
- the manner in which sponsor's own funds are to be contributed to the project vehicle (ie, if funds are coming from offshore through what countries or entities should those funds be channelled); and
- the financiers' security requirements;
- the rating of the project vehicle itself or the project debt.

How is the Project to be Financed?

One of the initial issues to be considered by a sponsor is whether it will finance the project out of its own internal cash flows or perhaps by undertaking a corporate fund raising or will raise project finance.

This will depend on a number of factors including:

- the financial strength of the sponsor;
- the ability of the sponsor to raise additional corporate debt;
- the commercial consequences of the sponsor raising additional corporate debt (eg, on any credit rating);
- the risk profile of the project;
- the risk appetite of the banks in the relevant market for a project with such a risk profile; and
- the impact of project financing covenants and restrictions on the sponsor's business.

In terms of the financial strength of the sponsor, it can be the case that even if the sponsor is not financially strong, it may still be able to raise project finance because the project itself is robust and can support project financing.

Often the more problematic issue for smaller sponsors is not the ability to raise project finance but access to equity funds to make the required level of investment in the project. Project financiers will usually not lend more than 70-75% of the total project cost and may in fact only be prepared to lend less than this depending on the project's risk profile. The sponsor must contribute equity at the required level. If the sponsor does not have sufficient funds, it will need to attract equity investors to the project. Generally speaking, equity investors fall into two categories – industry investors and financial investors. Major industry investors are likely to have strict return on equity requirements and, depending on the level of investment, may wish to have a significant involvement in the project vehicle. Financial investors are less likely to be interested in taking construction risk and may only want to be involved after the project has been completed.

A strong sponsor may be able to fund its equity investment out of internal financial resources or by undertaking a corporate fund raising. However, there may be other reasons why a strong sponsor might wish to utilise project finance even if it has access to sufficient financial resources or can raise corporate funds. The timing may not be right for accessing the market for additional corporate fund raising or there may be competing uses for corporate funds which have priority. Raising additional debt may also have an adverse impact on a company's credit rating. Utilising project financing may provide a sponsor with better return on equity than using internal funds and may provide taxation benefits (in some cases in more than one jurisdiction because of the different treatment of the same item under tax laws of different countries).

The risk profile of the project will affect the availability of project financing – the riskier the project the less the quantum of debt which banks are likely to be willing to lend against the project and the greater the amount of equity that will be required. Project financing will also be affected by the risk appetite of banks in the relevant market. Different banks have different appetites for different types of projects and the risks associated with them. This can be due to some banks having a greater degree of familiarity with the particular type of industry in which the project is being undertaken and therefore a better understanding of the risks inherent in that industry. This can be reflected in quite marked differences in pricing offered by different banks for project financing the same project.

The other issue which can be relevant is the impact of project financing covenants and restrictions on a sponsor's business. This is discussed in detail below. However, under a project financing structure, there will be restrictions on the sponsor's ability to access cash flows from the project. This is controlled through the use of ratios. In certain circumstances, where ratios fall below the specified level, cash can be locked up in the project for extended periods and then swept to prepay debt. In addition, project financiers may require cash sharing when the project is running well again reducing the free cash available to the sponsor.

Is the Sponsor Subject to Restrictions which may Impact any Project Financing?

Another factor which needs to be considered at an early stage in developing the financing plan is the impact of any sponsor negative pledge arrangements on any proposed project financing structure.

Many major corporations structure their corporate financing arrangements on a so called negative pledge basis – this simply means that the company borrows or raises funds supported, not by granting security, but by giving undertakings relating to the conduct of the company's business. Such negative pledges usually restrict the raising of additional funding, the granting of security and the giving of guarantees. Sponsors which are likely to require to undertake project financing as part of their business activities in developing projects will often ensure that the terms of the negative pledge permit this activity on some basis

One common approach in negative pledges is to divide the corporate group into restricted and unrestricted subsidiaries – restricted subsidiaries are subject to all of the requirements of the negative pledge (ie, they cannot raise debt or grant security) but unrestricted subsidiaries are outside the negative pledge and can raise project finance and give security over project assets. In addition, the negative pledge may permit the sponsor to invest in unrestricted subsidiaries at a specified level.

The terms of any such negative pledge need to be carefully reviewed to ensure that the project financing structure will not contravene the negative pledge. This

will be relevant to the project security structure (particularly to sponsor mortgages over shares and subordinated debt in the project vehicle) and to the ability of the sponsor to inject equity into the project at the required level. Also, under some hybrid financing structures, the sponsor may wish to guarantee the project debt until completion –again care must be take to ensure that the sponsor can in fact provide such a guarantee and, if not, how the project financing arrangements can be structured to accommodate this approach.

Under most project financing structures, the financiers will require security not only from the project vehicle but also over shares in, and subordinated loans to, the project vehicle held by the sponsor. The sponsor may be able to provide security but may not be able to undertake liability for the project debt. Can the sponsor provide effective security?

In Australia, it is almost the universal practice for limited recourse securities to contain a personal covenant by the borrower to repay the secured money, but for the financier's right to enforce that personal covenant to be restricted to agreed sources of repayment.[4] There is authority that it is possible to create a security in which there is no personal covenant to pay, with the practical effect that the borrower has an option whether or not to repay the secured money and, if the borrower does not, the financier is entitled to exercise its power of sale.[5] The reason for the Australian practice seems principally to be a concern about the possibility that a total elimination of personal liability could amount to a release of the borrower rather than a limited covenant not to sue.[6] This concern seems cautious particularly in light of the authorities relating to the personal liability of trustees. As long ago as 1879, Lord Cairns LC said:

> "I know of no reason why an executor under English or Scotch law, entering into a contract for payment of money, with a person who is free to make the contract in any form he pleases, should not stipulate by apt words that he will make the payment, not personally, but out of the assets of the testator."[7]

However, some commentators have correctly noted that conveyancing statutes in some Australian states require there to be a breach of covenant before a mortgagee's power of sale can be exercised.[8] If such a statute applies, this clearly necessitates the inclusion of a personal covenant. Additionally, an explicit but

[4] The dangers of not integrating a limited recourse clause with the other provisions of a document are illustrated by *Producers and General Finance Corporation Ltd* (1938) 40 WALR 34. In that case, a proviso limiting the personal liability of the third party guarantor to the mortgaged property was held to be ineffective on the basis that in the circumstances the limitation completely negated the personal covenant of guarantee. Although the method of construction and approach of that case is now largely outdated, it still illustrates the importance of properly integrating limited recourse provisions with the balance of the document.

[5] *National Provincial Bank Ltd v Liddiard* [1941] Ch 158 at 161.

[6] J Lehane, "Joint Venture Finance and Some Aspects of Security and Recourse", R Austin & R Vann (eds), *The Law of Public Company Finance* (LBC, Sydney, 1986), p 514 at 535.

[7] *Muir v City of Glasgow Bank* (1879) 4 App Cas 337 at 355, 356.

[8] T Lennox, *Australian Corporate Finance Law* (Legal Books, Sydney, 1994), at para 6.460. See as an example, s 108 of the *Transfer of Land Act* 1893 (WA).

limited covenant to pay in a security created by deed has the effect of extending the limitation period from six years (for a simple contract debt) to 12 years (for a specialty debt).

Subject to these considerations, there is no reason why, where the subject matter of the security is not real property, a valid security interest cannot be granted by a third party over shares in and subordinated loans to the project vehicle without a personal covenant by the third party to pay the secured money. Such an approach may need to be adopted where the sponsor holds shares or other interests in the project vehicle directly and is subject to a negative pledge which restricts the giving of guarantees or a covenant to pay in respect of project finance debt.

What will be the Impact of Project Financing Covenants on the Sponsor?

In any project financing, the financiers will look primarily to the cash flows of the project for their security and ultimately repayment of their debt. For this reason, project-financing arrangements usually require that:

- cash flows of the project pass through project accounts under the control of the financiers;
- the application of cash is prescribed in detail in a payment "waterfall" in the project financing documents;
- "free" cash (ie, cash available after payment of operating costs, debt service and payments to reserve accounts) can be required to be retained in the project in certain circumstances (ie, rather than paid to the sponsor) when the project is under performing; and
- free cash may be required to be shared between debt and equity providers when the project is performing as forecast.

Sponsors need to understand the impact of these restrictions on their business particularly during times when cash from the project cannot be accessed.

Project ratios

Project ratios are a common feature of project financing structures. There are many ways in which the existing and future strength of a project can be measured through the use of financial or physical ratios.

In the case of financial ratios, it is usual to focus on cash flows (either actual or projected future cash flows), which, in some cases, will be converted to a net present value (NPV). The more commonly encountered net present value cover ratios include:

- *Project life cover ratio (PLCR):* This is the ratio of the net present value of cash flow available for debt service (ie, revenue less operating costs, maintenance

capital expenditure and taxes) (CFADS) over the life of the project to the debt service obligations to the financier over that period. In practice it may be more complicated. For example, if the financier is concerned about abandonment costs at the end of an oil project, it might require the NPV to exclude that part of the project covering the last 25% of the project reserves.[9]

- *Loan life cover ratio (LLCR):* This is the ratio of the NPV of CFADS over the scheduled term of the loan to the amount of the debt service obligations to the financier over that term.

Other financial ratios which are commonly used, are:

- *Debt service cover ratio (DSCR):* This is the ratio of CFADS over the relevant period prior to the calculation date (ie, the date on which the ratio is calculated and tested) to the debt service obligations during the same period.
- *Interest cover ratio (ICR):* This is the ratio of CFADS over the relevant period prior to the calculation date to the project's interest payment obligations.

An example of a physical ratio is the reserve tail ratio (RTR). This ratio is used in mineral and petroleum projects where there is a wasting asset. It is a ratio of the reserves that will remain to be mined after the final repayment date to the total reserves as at the first drawdown date. This is a way of ensuring that there is a substantial tail of reserves available and achieves the same effect as the exclusion of the last 25% of project revenues referred to in the discussion of project life cover ratios above.

The PLCR and LLCR are forward looking (ie, based on projected future cash flows) and are calculated for a series of dates (usually debt service dates or monthly, quarterly or six monthly) during the projected life of the project or facility. The DSCR and ICR are usually historic (ie, based on a period of time ending on the calculation date), but may also be forward looking.

In setting ratios relating to periods of time, sponsors need to be conscious of the need to ensure that the ratio is measured over a sufficient period of time so that the effect of unusual events is "smoothed out". Often, for example, to address this issue DSCR is measured over a rolling 12-month period from each calculation date.

Project ratios may be used for a wide variety of purposes. For example, they may be used:

(a) to determine the maximum amount which may be drawn under the facility. This process is referred to as "debt sizing". It is usually expressed as a condition precedent in the credit facility agreement. The procedure is that the financial model is run immediately prior to financial close with the most up-to-date data available on interest rates and the effect of any interest rate hedging (and any other variable inputs). The financial model must then demonstrate that the project will meet certain cover ratios (usually debt service and loan life cover ratios) over the forecast term of the debt. The size

[9] See G Vinter, *Project Finance* (2nd ed, Sweet & Maxwell, London, 1995), para 4.41.

of the debt may be reduced if the debt size is such that the financial model indicates that the project will not comply with these ratios;

(b) to determine interest rate margins (eg, as ratios improve, the interest rate margin may decrease);

(c) to determine when and to whom money may be released from project accounts or must be retained in project accounts ("cash lock up");

(d) to determine when "cash sweep" should occur (ie, where the project is performing below expectations);[10]

(e) to determine if money may be released to the project vehicle;

(f) as a trigger for the occurrence of an event of default or a review of the facility by the financier.

In most project financings, a computer generated financial model will be agreed between the parties at the commencement of the project which will be used to make the requisite calculation of financial ratios. This is often referred to as the "base case" model and is usually updated at regular intervals over the course of the project to reflect changes in the circumstances of both the project (eg, patronage and capital and operating expenses) and the economy generally (eg, currency and commodity prices and interest rates). Because any change to the inputs to the financial model (eg, on account of changes in commodity prices or interest rates) may be highly contentious, there is often a dispute resolution mechanism in the credit agreement to resolve disputes between the borrower and the financier and their respective agents.

Distribution of project cash flows

In any project financing, the financier will be concerned to ensure that the project's cash flow is adequate to satisfy debt repayment obligations. For this reason, the project financing documentation will generally include provisions dealing with how project cash flows may be used. Typically, the borrower will be required to use project cash flows first in satisfaction of project expenses and secondly to repay project indebtedness and make payments to reserve accounts. In broad terms, cash flow available in excess of these amounts is the "excess cash flow". The financier will also typically seek to structure how this excess cash flow can be distributed. The order in which project cash flows may be distributed is known as the cash flow "waterfall" or "cascade".

The order of application of project cash flows may be adjusted during the course of the project to protect the financier. For example, when financing a wasting or deteriorating asset, a financier will be concerned if the borrower exploits the highest grade reserves at the beginning of the project (a process known as high grading), leaving the lower grade reserves for the later higher risk part of the project. To address this risk, many project financings require the borrower to make higher payments than those scheduled if the loan life cover ratio[11] falls below a specified ratio. These higher payments would usually be all of

[10] For more on cash sweeps see "Distribution of project cash flows", above.

[11] See paragraph "Project ratios", above.

the excess cash flow of the project, or such proportion of it as is necessary to enable the loan life cover ratio to remain at the agreed level.

Other methods commonly used to protect financiers' access to cash flows include "cash sharing" and "mandatory cash sweeps". These techniques are designed to effectively amortise debt at a rate faster than the scheduled amortisation. The concept of "cash sharing" entitles the project financier to receive a share of the cash flow that would otherwise be available for distribution to the project sponsor. So, if on a calculation date, after payment of all amounts having priority of payment in the cash flow waterfall, there is an amount of cash available for distribution to the project sponsor, that amount is shared in agreed proportions between the financier and the sponsor. Cash sharing can sometimes be expressed to apply when the project is performing above a pre-agreed level of DSCR.[12] It is a device intended to accelerate amortisation of the project debt when the project is performing above cash sweep DSCR levels. The additional cash is usually applied in inverse order of maturity (ie, against the last scheduled principal amortisation including any bullet repayment) thereby reducing the financier's risk at the back end of the financing (ie, when there may be a refinancing risk). If the cash is so applied, there is no immediate impact on the borrower's debt service requirements. For this reason, sponsors often seek such cash to be applied pro-rata across all remaining debt service instalments.

One matter which sponsors and borrowers must be careful not to overlook is to ensure that amounts which have been subject to cash sharing once but are locked up are not then subjected to cash sharing on a later ratio calculation date. In other words, if available cash is subject to cash sharing on a ratio calculation date but the balance (ie, after cash sharing) remains locked up in the proceeds account, that balance should not then be subjected to cash sharing on the next ratio calculation date. This is particularly relevant where available cash is determined on a ratio calculation date by reference to the cash balance in the proceeds account.

If the project is not travelling as well as forecast in the financial model, and the forecast DSCR[13] levels are not being met, usually, the project will not be permitted to make distributions (ie, return cash) to the equity parties/sponsors. This often occurs in the initial stages of a project. When this occurs, the project is described as being in "lock up". Often when lock up first occurs, the cash locked up will remain in the project (ie, it will stay in the proceeds account). However, if lock up continues for an extended period (say over two or three ratio calculation dates), the financiers will be entitled to "sweep" the cash locked up and apply it in payment of the principal outstanding (again in inverse order of maturity). This is known as a "mandatory cash sweep".

Control accounts

Many project financings require the borrower to establish a variety of project accounts, often under the control of the financier. These may include:

12 See paragraph "Project ratios", above.
13 See paragraph "Project ratios", above.

- *Disbursement account* – this is an account into which all drawings of the facility and any additional equity is deposited. In cases where tight control is required by the financier, withdrawals may, for example, only be permitted against evidence of expenditure, certification of satisfactory completion of works and confirmation that the cost to complete is not more than the undrawn balance of the facility.
- *Proceeds account* – this is an account into which the project revenues are paid.
- *Debt service reserve account* – this is an account in which moneys are set aside to enable payments of principal and interest to be made to the financiers, if project revenues are not available.
- *Other* – depending upon the size and nature of the project there may be a variety of other accounts. For example, a compensation account for non-revenue items such as an insurance payment or expropriation or other compensation or a maintenance or capital reserve account to cover significant future maintenance or capital expenses.

The control accounts provide a framework of control over the project vehicle's activities without involving the financier in the project vehicle's day-to-day business. For example, they enable the financier to monitor the project cash flows, and to ensure the project vehicle maintains adequate reserves to cover contingencies. They also provide the means by which the financier is able to specify the order or "cascade" in which project cash flows are applied by the project vehicle. They are particularly useful if the project vehicle is financially troubled, as they assist the financier to maintain a fair degree of control over the business while the pre-agreement of constraints on withdrawals makes it difficult to characterise such control as the work of a "shadow director".

Usually, the accounts are held with the agent for the project financiers and are subject to a charge under the project securities. Withdrawals often require the signatures of an officer of the financier and an officer of the project vehicle.

Completion test

In "greenfield" projects, there is invariably some form of testing required to determine whether completion has been achieved. Completion is a significant milestones in any project for a variety of reasons. In some project financings, the sponsor may not obtain the benefit of limited recourse until completion is achieved (ie, this can be the "trigger" for the financing to convert from recourse to limited recourse). In most cases, if completion is not achieved by a certain date, this will give rise to an event of default. Failure to pass the completion test can also trigger an ability for financiers to draw upon any contingent equity support provided by the sponsor to meet the cost of additional works to achieve completion.

In projects which involve the construction of processing plant (eg, such as in the petrochemical industry), the completion test is likely to comprise a variety of components such as:

(a) ensuring that all support infrastructure is completed and operational (such as water supply facilities, port facilities, gas pipelines, product load out pipelines, land corridors);

(b) ensuring that the project vehicle has adequate operational personnel;

(c) ensuring that the necessary preparatory work has been completed before the technical testing of the plant occurs. This will include matters such as completion of work under the EPC Contract, implementation of a safety plan, handover of necessary manuals;

(d) ensuring that the plant is able to operate according to the agreed technical specifications and can produce product complying with specification. In addition, there may be a requirement that product is delivered to the port, loaded out and shipped;

(e) finally, after the technical testing has been completed, there will be a requirement that:
   (i) the project vehicle is not aware of material defects in the plant which will not allow it to operate at the agreed levels;
   (ii) there be no material ongoing disputes with the EPC Contractor;
   (iii) all permits and licences are in place; and
   (iv) all construction related payments have been made.

The financiers will usually have an independent technical expert appointed who will supervise the completion testing for financiers.

From a sponsor perspective, possibly the greatest concern in relation to any completion test is to ensure that, if the strict technical requirements of the test are not met but the plant is still capable of operating at satisfactory levels sufficient to service debt and amortise debt within the agreed amortisation period, completion can still occur. Therefore, flexibility needs to be built into the testing regime to accommodate this. Another major concern is to ensure that the test period can be extended in the event of force majeure or, at the election of the project vehicle for an agreed further period, to manage the risk that the plant may "trip" and need to be shut down temporarily during the test period. Subject to ensuring that such a right cannot be abused, the project vehicle should also have the election to cease the test and restart it.

As noted above, usually if completion is not achieved by a certain date, an event of default will occur under the project financing. Rather than have default occur, a sponsor might wish to give itself the ability at that time to provide a corporate guarantee of the debt until such time as completion is achieved. Upon completion being achieved, the guarantee of the debt will cease and the project will become limited recourse. This option is only likely to be available to a sponsor with an investment grade credit rating or better.

Finally, if contingent equity support is provided, sponsors need to ensure that such support can only be drawn down progressively as and when required to meet the cost of additional work to achieve completion. Contingent equity support should also be capped at an agreed amount so as not to expose the sponsor to an indeterminate liability to contribute funds towards achieving completion.

The Choice of Project Vehicle

In a conventional project financing involving only a single project sponsor, the project sponsor will either own the project directly or, more likely, hold the project through a special purpose vehicle. At least historically, there have been instances in resources project financings where the sponsor has participated directly in the project with recourse limited to the project assets. Invariably, today sponsors participate through special purpose companies or entities whose sole activity is to undertake the project.

The use of a special purpose vehicle will not necessarily insulate the project sponsor from responsibility for problems with the project. For example, in the *Antico* case,[14] Pioneer, as the controlling shareholder of Giant Resources NL, and Pioneer's nominee directors were successfully attacked under the insolvent trading provisions of the *Companies Code*. Pioneer, as controlling shareholder, was found to be a shadow director for a period because it had effective control of the company through its 42% shareholding and because it exercised control in practice. In that case, three major decisions were made by Pioneer without receiving independent consideration by the board of Giant Resources. In one case the board of Giant Resources simply accepted Pioneer's decision as a fait accompli.

Since then, s 588V of the *Corporations Act* has made it easier for manipulation of a special purpose vehicle by a project sponsor to be attacked. It provides that a holding company of a subsidiary may, subject to certain defences, be liable to the subsidiary's liquidator for loss or damage suffered in relation to a debt incurred when the subsidiary was insolvent or if the subsidiary became insolvent by incurring that debt.

However, it is also worth noting that s 187 of the *Corporations Act* now allows a director of a subsidiary, with an appropriate provision in its constitution, to act in good faith in the best interests of its holding company (as opposed to acting solely in its own best interests) provided that, at the time of the director's act, the subsidiary is not insolvent and does not become insolvent because of the director's act. It should be noted that s 187 will not apply to a special purpose vehicle which is not a wholly owned subsidiary (such as an unincorporated joint venture).

In the case of a foreign sponsor, it is not uncommon to find that the project sponsor uses two or more special purpose vehicles with, for example, the project vehicle being incorporated in the country of the project and the holding company of the project vehicle being incorporated in the project sponsor's country or some third jurisdiction. In theory, this is to enable easy disposition of the project (through the sale of the shares in the intermediate holding company) if, for political or taxation reasons, it is difficult to dispose of assets or shares in the country in which the project is situated. There may also be taxation or other benefits in such a structure.

[14] *Standard Chartered Bank of Australia Ltd v Antico* (1995) 13 ACLC 1381 at 1387.

If there is to be more than one participant in the project, there are a number of choices for the project vehicle including an incorporated joint venture, partnership, unit trust, or unincorporated joint venture. Each raises its own issues for the financier of a project.

Incorporated joint venture

An incorporated joint venture uses a company as the project vehicle. Each of the project sponsors is issued shares in the vehicle.

The constituent documents of the company will usually set out the entitlement of the parties to seats on the board, voting rights at both board and shareholder levels, powers of the board and reserved powers requiring a special or unanimous resolution, terms on which nominee directors may act, quorums of meetings of directors and shareholders, rights of pre-emption and options over shares, and the like. The documents may be supplemented by a shareholders' agreement which will usually deal with restrictions on disposals of shares, pre-emptive rights, representation of directors and management, business plans, budget and financial reporting, dividend and borrowing policy, right to information, and dispute resolution.

The principal advantage of the incorporated joint venture is that, in common with the use of a special purpose company by an individual project sponsor, it largely insulates the sponsors from personal liability for the carrying on of the project. As a shareholder, a project sponsor is largely protected from direct attack by the creditors of a project company. However, the project sponsor will be vulnerable to attack if it is the holding company of the project company and the project sponsor or its directors are aware that there are reasonable grounds to suspect the insolvency of the project company or the project sponsor's control over the project company means that it is reasonable to expect the project sponsor or its directors would be aware of the project company's insolvency.[15]

Partnership

A partnership is defined by the various Partnership Acts in force in the states and territories of Australia as "the relationship which subsists between persons carrying on business in common with a view of profit". Although the concept of a "business" is usually associated with a need for "system and repetition", there is ample authority that a partnership can be formed for the purpose of a single project.[16]

Partnerships have been used increasingly in Australia as vehicles for carrying on energy and infrastructure projects. Partnerships are "pass through" vehicles for income tax purposes – they are not separately taxed but profits and losses flow

[15] *Corporations Act*, s 588V.

[16] *Canny Gabriel Advertising Pty Ltd v Volume Seale (Finance) Pty Ltd* (1974) 131 CLR 321 and also see *Partnership Act* 1981 (Qld), s 35(1)(b); *Partnership Act* 1892 (NSW), s 32(b); *Partnership Act* 1958 (Vic), s 36(b); *Partnership Act* 1985 (WA), s 43(b); *Partnership Act* 1891 (Tas), s 37(b).

through to the partners and are taxed in their hands. The fiduciary obligations partners owe to each other, the ability for individual partners to pledge the partnership's credit, and the fact that partners have no title to specific partnership assets, give rise to certain risks for project sponsors considering the use of such a project vehicle. However, many of these risks can be minimised through the use of special purpose vehicles to act as partners and through tight control of the activities of these vehicles by project financiers.

Under the various Partnership Acts of each state, a partner has no direct interest in the assets of the partnership and has only a right to its share of profits and, on dissolution of the partnership, a right to the relevant proportion of the surplus remaining after realisation of all assets and payment of partnership liabilities. This makes financing by individual partners of their contribution to the partnership difficult because they cannot give the financier a direct security interest in the partnership property. For this reason, it is usual for the members of a partnership to borrow and give security collectively as a partnership rather than individually. Arguably, a partnership cannot give effective security unless all of the partners are joined in, and are parties to, the relevant mortgage or charge.

Unit trust

Unit trusts are used from time to time as the vehicle by which groups of project sponsors hold project assets.

The unit trust is a trust in which the beneficial interest in the trust property is divided into units which may be dealt with by the owners of those units. Usually such a unit trust will be structured with a special purpose vehicle as the trustee and the trust deed will exclude unitholders from personal liability for the activities of the trust. Experience indicates that they are successful in excluding personal liability.

Complex taxation rules apply to the taxation of trusts. One problem in using a trust is that any tax losses are trapped within the trust. This may be a particular problem for projects during the construction and ramp up phases of a project.

There are several other issues worth noting in relation to the use of trusts:

(a) first, many institutional investors (such as industry superannuation funds or managed infrastructure funds) are trusts. If these vehicles invest in "greenfield" projects, they are often likely to require the ability to earn a return on their investment during the construction period of the project. During this period, the project is not earning revenue so how is this requirement dealt with? Usually, these investors will contribute their equity in the form of subordinated debt which will carry an agreed rate of interest during the construction term. That interest will be funded out of the finance facilities for the project. Such interest will cease to be payable should the project go into default during the construction period;

(b) secondly, financiers will invariably require special trustee representations, warranties and undertakings which relate to the trust itself. Care needs to be

taken to ensure that the trustee only gives such representations, warranties and undertaking in its trustee capacity only and not in its personal capacity – trustees should only give representations, warranties and undertakings in their personal capacity where they relate to the trustee itself;

(c) thirdly, trustees, responsible entities and custodians invariably have standard limitation of liability clauses which need to be included in all documents to which they are a party. Much time can be spent in negotiating the wording of these clauses and then ensuring they are consistent across all project and financing documents. Usually the clauses will require that personal liability arises on the part of the trustee or responsible entity in the case of fraud, gross negligence or wilful misconduct by that entity or, in some cases, for giving incorrect representations or warranties or breaching particular undertakings; and

(d) finally, under the laws relating to managed investment funds, some trusts are required to use custodians to hold certain assets of the trust. Often these custodians need to be made party to the financing documents in order to grant security over the relevant assets. However, custodians will usually resist being subjected to the full suite of representations, warranties and undertakings in the same way as other security providers. For example, they may refuse to give a covenant to pay. One approach is to impose on the custodian only those minimum requirements necessary to create and maintain a valid security interest and then have the trustee or responsible entity undertake to ensure that the custodian complies with all the other undertakings in the security. This is considered satisfactory as the custodian, generally speaking, must act as directed by the trustee or responsible entity.

Unincorporated joint venture

The unincorporated joint venture is a popular form of project vehicle in Australia because it is more flexible than a partnership or incorporated structure. For taxation purposes, a joint venturer is not treated as a separate entity from the joint venture. A joint venturer may directly depreciate its interest in the joint venture and take its income and capital gains and losses from the joint venture's activities.

The typical joint venture is governed by a joint venture agreement which attempts, so far as possible, to make the relationship between the parties purely contractual and free of any fiduciary obligations between venturers. The agreement will usually define the project which will be the subject of the joint venture, confirm that the parties hold joint venture assets as tenants in common and will deal with them only as provided in the agreement, provide for payment of project expenses proportionately by the joint venturers, appoint a manager/operator to run the project for the venturers, provide a decision-making process, and set out the rights of joint venturers on default. Although other approaches can be taken, joint venture agreements usually deal with the prospect of default by a joint venturer either through dilution of the defaulting joint venturer's interest in the project to the other joint venturers or by the grant of a cross charge by each

joint venturer over its interest in the joint venture and any product it derives from the joint venture, or both.[17]

An essential feature of every joint venture agreement is that expenses are shared but revenues are not. When project expenses are incurred, the manager or operator of the project makes a cash call to the joint venturers requiring them to pay the cash call in their agreed proportions. There is, however, no sharing of revenue from the project; rather, each joint venturer takes the product of the joint venture in kind and is obligated to sell it to its own account.

The structure of the joint venture and the way in which the parties carry it into effect is significant because there is a fine line between a joint venture and a partnership. For there to be a partnership there must be a business carried on by persons in common, with a view of profit. It is usually argued that most resources joint ventures are not partnerships because:

(a) they are not being carried on in common; and
(b) they are being carried on with a view to personal profit rather than collective profit.

Surprisingly, despite the continual use of the unincorporated joint venture over the last 40 years, the concept has not been authoritatively endorsed by Australia's highest court[18] and has been attacked by some commentators as constituting a partnership.[19] Nevertheless, most commentators have supported the joint venture as a concept separate from partnership. It is probably now too late for the High Court to change the law after having had the direct opportunity to do this on at least three occasions.

If financiers are lending to the venturers in a joint venture collectively, it will be of little significance whether or not the relationship between the venturers is that of partners or of joint venturers. On the other hand, if financiers are lending to an individual venturer, then it is very important because a partner is unable to charge its share of the partnership assets; it can only charge its share of the surplus remaining after partnership liabilities have been satisfied. Even if the relevant property is registered in the name of the partners in their relevant partnership shares, it is probable that the partners hold that property on trust for the partnership, in which case if the security is given in breach of trust it may be set aside except to the extent protected by statutory indefeasibility provisions.[20]

[17] As to the nature of the relationship between joint venturers and its effects on financiers see R Millhouse, "Security Over a Joint Venturer's Rights and Interests in an Unincorporated Joint Venture", *Banking Law and Practice Conference* (1995) at 181 and J Lehane, "Joint Venture Finance and Some Aspects of Security and Recourse", in R Austin & R Vann (eds), *The Law of Public Company Finance* (LBC, Sydney, 1986), p 514.

[18] *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1.

[19] J McPherson, "Joint Ventures", in P Finn (ed), *Equity and Commercial Relationships* (LBC, Sydney, 1987), p 19.

[20] At least one learned commentator has suggested that this may not be as great an issue as suggested here. Justice Lehane has suggested that a partner, or a joint venturer in circumstances where the joint venture has been categorised as a partnership, can charge its beneficial interest in the partnership assets provided that the terms of the partnership agreement allow it to do so and the other partners consent. It would appear that the

Interestingly, unincorporated joint ventures have been used in more recent years as project vehicles to undertake projects in the electricity industry (as owner and operator of a power station) and in the transport industry (as owner and operator of a railway). The use of the unincorporated joint venture in these circumstances blurs the distinction between partnership and joint venture. In the context of a resources project, one can see that the joint venturer is entitled to, and can take and dispose of, its share of the product. How does a joint venturer take and dispose of its individual share of the electricity produced by a power station or its share of freight transported for customers on a railway? These issues have not been considered by the courts in Australia to date.

If the financier is funding a joint venturer or the joint venturers on a several basis, the terms of the joint venture agreement must be scrutinised carefully, not only to ensure that the joint venture does not impose unreasonable or inappropriate obligations on the borrower but also to ensure that the borrower's rights against the other venturers are adequate. For a financier, the most important provisions are the terms on which a venturer may charge its interest and the default provisions. There are however, a host of other issues including the enforceability of options and pre-emption rights under the perpetuities legislation in the relevant state or territory.

The joint venture agreement will generally exclude fiduciary obligations as between venturers (to the extent that this is possible)[21] and prohibit the venturers from disposing of or partitioning their interest in the joint venture property except in accordance with the terms of the joint venture agreement.

Clearly, the possibility of forfeiture of a defaulting venturer's interest would be a major concern to a financier, even though the enforcement of forfeiture provisions would in some cases be subject to relief against forfeiture. If a venturer's interest in the project can be diluted (ie, reduced) as a consequence of a default under the joint venture agreement or a decision not to meet a cash call, then the dilution formula should be carefully examined to ensure that the rate at which the venturer's interest is diluted is not so harsh as to be penal.[22]

reasoning behind this conclusion is that, where the other partners have consented to the charge, those partners, as equitable interest holders in the partnership, have agreed to cede their equitable priority to that of the partner seeking to independently mortgage its interest and its financier. Alternatively, he argues the nature of the beneficial interest of the partnership and the rights of partners under the various partnership acts to exclude property from partnership assets allows partners, with the consent of the other partners, to carve out their interest from the partnership property for the purpose of charging that interest. It is, however, open to argument whether the right of a partner to charge its individual interest and the ability of the other partners to consent to the charge is consistent with the obligation under each Partnership Act for partners to hold partnership property and apply it exclusively for the purposes of the partnership. For more on this issue see J Lehane, "Current Legal Issues Relating to Lending to Trusts and Partnerships" in *Banking Law and Practice, 14 Annual Conference Papers*, (Sydney, 1997), p 301.

[21] See *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1; *Noranda Australia Ltd v Lachlan Resources NL* (1988) 14 NSWLR 1; *Diversified Mineral Resources NL v C R A Exploration Pty Ltd* (1995) ATPR 40-381.

[22] Equitable relief against forfeiture is a highly technical area and the scope for its application may be limited in project financings which have elaborate and highly

If the joint venture agreement provides for cross charges (ie, charges by each joint venturer in favour of the other joint venturers over each venturers project interest to secure its obligations to pay cash calls and other joint venture expenses) then, usually, the joint venture agreement will require that the financier and the joint venturers enter into a deed of covenant at the time of entering into the security. This will deal with the possibility of forfeiture or dilution by obliging non-defaulting joint venturers to give notice of default to the financier and allowing the financier a cure period to rectify the default. Care should be taken in drafting this provision to ensure that the financier is also protected where the default is of a kind which is not remediable, such as the borrower going into liquidation.

The deed of covenant must regulate priorities between the joint venture cross charges (if any) and the financier's security. It is well accepted by financiers in Australia that a joint venture cross charge should rank in priority over a financier's security but only to the extent that the joint venture cross charge secures calls under the relevant joint venture agreement and, if necessary, excludes calls in relation to extensions of the project or new projects entered into under the joint venture agreement which have not been approved by the financier. One commentator has, however, queried whether an uninsured claim by a third party against a project manager for environmental damage should rank ahead of project financiers?[23]

Usually, the deed of covenant will provide that the exercise by the financier of the power of sale is subject to the pre-emptive rights or options to purchase of the other non-defaulting joint venturers. Although this complicates any sale, it does not seem that joint venturers are prepared to give up their rights to assist financiers.

How are the Sponsor's Funds to be Contributed to the Project Vehicle?

Sponsors need to consider how funds are to be contributed to the project vehicle. Generally speaking the choice is between "true" equity (such as ordinary shares) and debt instruments (such as either loans which the financiers will require to be subordinated to the project financing or instruments such as redeemable preference shares). The choice will be driven principally by taxation considerations (both domestic and international) affecting the project vehicle and, in the case of a foreign sponsor, the sponsor itself.

Interest payable on subordinated loans borrowed by the project vehicle from sponsors will be deductible for taxation purposes in Australia provided the debt instrument meets the requirements of debt under the debt/equity rules in Div 974 of the *Income Tax Assessment Act* 1997 (Cth) and other provisions which can

regulated default and cure regimes (see P Cornwell, "Project Finance", in *18th Banking Law Conference,* pp 11-14). For a recent illustration of the pitfalls of relying on relief against forfeiture see *On Demand Information plc v Michael Gerson (Finance) plc* [2000] 4 All ER 734.

23 T Brown, "Project Financing", *Banking Law and Practice Conference Papers*, (1992), p 384.

affect deductibility do not apply. Dividends payable in respect of shares will not be deductible (unless the equity instrument is characterised as debt under the debt/equity rules) but may be received tax free by the recipient if they are franked. Subject to relevant tax treaties, both interest and dividends will attract Australian withholding tax.

Foreign sponsors will also need to consider whether it is more tax efficient to contribute funds through entities established in a jurisdiction other than the sponsor's home jurisdiction. For example, a sponsor which has assets in a jurisdiction outside the sponsor's home jurisdiction may receive more favourable tax treatment if it makes its equity investment in an Australian project through a subsidiary or branch established in a third jurisdiction. Balanced against any more favourable tax treatment offered by a third jurisdiction, however, must be matters such as exchange controls (which can affect the ability to invest funds or to convert them into other currencies once received and to remit them to the home jurisdiction) and political risk (particularly the risk of expropriation of assets by government). Whilst structures can be developed to mitigate these risks, financiers are unlikely to accept shares in, or loans to, the project vehicle being at risk of expropriation.

One final matter for a foreign sponsor to consider is how any equity investment in an Australian incorporated project vehicle will be held – in particular, will the investment be held directly by the foreign sponsor or through an Australian incorporated holding entity. The relevant considerations are the tax rules in the sponsor's home jurisdiction, the Australian tax rules and the security requirements of the financiers. In relation to the last matter, financiers invariably require security not only over the assets of the project vehicle but also over the shares in, and subordinated loans to, the project vehicle. The use of an Australian incorporated holding entity will allow such security to be given to the financiers without involving the laws of a foreign jurisdiction. Otherwise, financiers will require legal opinions as to the effectiveness of any security granted by the foreign sponsor under the laws of the sponsor's jurisdiction.

What Security will be Required by Project Financiers?

Wherever possible, financiers will seek to have security over all of the assets of a project which will, if the borrower defaults, entitle the financier to take possession of the project and its cash flows and, if necessary, to sell the project as a going concern. In many cases, this will not be the only reason for taking security, particularly if the project assets are of a kind which are difficult for a financier to manage or dispose of; for example, a plant for the treatment of hazardous waste. In fact, in many cases, financiers recognise that if the borrower cannot make the project work then it is unlikely that a receiver appointed by the financier will be able to do better. Nevertheless, project security will be taken for defensive reasons such as to obtain a ranking before unsecured creditors, and to prevent unsecured creditors dominating the borrower.

The main project security is usually an equitable charge over the project assets, which is fixed over as many of the project assets as possible and floating as to the remainder of the project. However, project financiers will often require, in addition to security over the project company itself, security over the shares in the project company by way of an equitable mortgage of shares. The reason this is done is to give the project financier the option, when security is enforced, of either selling the project assets or selling the ownership interests in the project vehicle. This can be relevant where, for example, the project vehicle has accrued tax losses.

If the borrower company has any non-project assets, it is desirable for project securities to extend to all of the assets of the borrower, so as to avoid the appointment of an administrator to the borrower interfering with the financier's powers of enforcement. Under the *Corporations Act*, a secured creditor may not, in general, enforce its security after the appointment of an administrator, unless the secured creditor has a charge over "all or substantially all" of the chargor's assets[24] and acts within 10 days of the appointment.

If the borrower has substantial non-project assets, it may well be that a conventional floating charge over its non-project assets will be unacceptable; if so, a so called "featherweight" floating charge may be of assistance. This is a charge which, insofar as it relates to non-project assets, gives unfettered powers to the borrower to dispose of and encumber non-project property. A featherweight charge is enforceable only upon the appointment of a receiver by the financier and then only after the appointment of an administrator to the borrower. It will usually provide that any moneys received on enforcement against an asset will be held on trust for the holder of any other security over the relevant asset. Invariably, in infrastructure projects, the borrower is a special purpose vehicle which will have no assets other than the project assets. However, sponsors are often concerned to ensure that the distribution account (into which any money to which they are entitled out of the cash flow waterfall) is outside the scope of the financier's security. This is one example of where a featherweight floating charge can be used to address the concerns of the financier and the borrower.

The project charge will usually be a comparatively short document because representations and warranties, covenants, and events of default are dealt with in the credit agreement. If the charge is granted to a security trustee, it is important to ensure that any reference in the charge to the security trust does not amount to a declaration of trust.

The charge will usually be fixed over as many of the project assets as possible. In some cases, the financier will not be content with a fixed charge and will require legal mortgages, for example, over land, mining tenements or shares. The financiers may require an assignment by way of security over key assets, for example, critical items of plant or key project contracts, particularly sales contracts and state agreements.

[24] *Corporations Act*, s 436C.

If the assignment involves sales proceeds or other book debts, there is still a debate over the ability of a financier to have a fixed charge or assignment by security over those book debts in circumstances where the borrower is free to deal with the proceeds of the book debts. The conventional view, until recently at least, is that there must be "some real and not illusory, consent and control provisions and defined procedures which regulate the use of sale proceeds by the borrower".[25]

In a project financing it is not uncommon to find such controls, particularly if the structure already involves the borrower establishing control accounts with the facility agent or security trustee. Until the recent decision of the Privy Council in *Re Brumark* (*Agnew v The Commissioner of Inland Revenue,*[26] there was an emerging strand of authority, based on some decisions of single judges, that such an elaborate procedure was not necessary and that it is possible to have a fixed charge over sales proceeds and other book debts so long as the security floats over their proceeds.[27] However, in *Re Brumark*, the Privy Council decided that it was not possible to draw a distinction between a book debt and its proceeds and that in order to have a fixed charge, the financier needs to exercise real control over the relevant book debt. Although *Re Brumark* is not binding in Australia, it is likely to be highly persuasive. In relation to project finance transactions, one commentator has noted that "it is clear that what the parties intend to create is a fixed charge and it is hoped that the courts will respect this. However, in a post-*Re Brumark/Re Cosslett* world, there is no guarantee that such measures (short of the extreme measure of the chargee having to physically approve each transaction) will escape recharacterisation by the courts. This uncertainty is regrettable."[28]

External collateral

Many project financings require external support from project sponsors, particularly prior to project completion. This support may be a straightforward parent guarantee or tangible security, a performance guarantee, a comfort letter which may or may not be intended to be legally binding or some indirect form of support such as a technology support agreement or an offtake agreement.

Equity injection

In most project financings, the project sponsor is required to contribute equity to the project. Project sponsors often prefer to defer the injection of their equity to completion of the project. For example, in the case of large construction

[25] A. Millhouse, "Project Financing", *Banking Law Association Conference Papers* (1992), p 362.

[26] [2001] 2 AC 710. Since affirmed by the House of Lords in *Re Cosslett* (reported as *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2001] 3 WLR 1347.

[27] See *Re New Bullas Trading Ltd* (1994) 12 ACLC 3203; *Mullins v The Queen* (1994) 75 A Crim R 173; *Whitton v ACN 003 266 886 Pty Ltd (in liq) (formerly Boswell Printing Pty Ltd)* (1996) 14 ACLC 1799; and, see also N Heng, "Taking Security Over the Cash Flow of Companies", (1997) 5 *Insolvency Law Journal* 174.

[28] Yuen-Yee Cho, "The Fixed and Floating Charge", *Australian Finance Law* (Thomson, Lawbook Co), 5th ed, at Ch 18, p 472.

companies which will often prefer to inject equity at the latest possible time so as to minimise the time in which sponsor cash is locked up in the project. Other sponsors, on the other hand, (particularly financial and constitutional investors) may prefer, however, to inject equity at financial close in the form of subordinated debt and receive (or accrue) a debt return on that "equity" until completion.

Where the project sponsor prefers to defer injection of their equity to completion, often the obligation to contribute equity is documented as an obligation to contribute upon the earlier of completion, the occurrence of an event of default, and a specified date. Where equity is "back ended" in this manner, the project financier may be asked to fund that equity from financial close to completion. If provided, this funding, or debt tranche, is in addition to the traditional limited recourse project debt tranche and is often referred to as an "equity bridge" facility. Financiers usually require that these equity bridge facilities be secured by letters of credit from banks with a specified credit rating or, if the sponsor is itself rated, by a corporate guarantee from the sponsor.

Performance guarantees

The term "performance guarantee" is not a term of art. It is often used loosely. Strictly speaking, a performance guarantee is a guarantee of an obligation to do something rather than an obligation to pay money, which creates a conditional debt obligation on the part of the performance guarantor. The most familiar performance guarantee is a completion guarantee which is an undertaking to ensure that completion of the project occurs by a specified date. If the borrower fails to achieve this, the guarantor is liable in damages. Other forms of completion guarantee include undertakings to cure defaults by a contractor, invest equity in the project, pay liquidated damages, and buy the financier's debt in the event of default.

The weakness of a completion guarantee is the need for the financier to prove the breach caused the financier's loss (eg, it might be argued by the guarantor that the project was inherently unprofitable); the loss was reasonably foreseeable at the time the completion guarantee was given; and, the financier took reasonable steps to mitigate the loss. In addition, the completion guarantor might seek to argue that supervening events frustrated the completion guarantee.

Letters of comfort

The difficulties with letters of comfort are well documented. The purpose of letters of comfort is to provide a formal, yet non-contractual and therefore unenforceable, assurance from a third party to the financier. However, as some letters of comfort have been found to create enforceable obligations to perform particular acts most are now expressly stated not to be legally binding. Care should also be taken in discussing and preparing comfort letters that the giver is not inadvertently liable in respect of a comfort letter on a non-contractual basis, such as misleading or deceptive conduct or promissory estoppel.

Although a letter of comfort may extend to anything, typically they deal with things such as the project ownership structure, availability of key personnel or resources, and the project sponsor's policy in funding subsidiaries or dealing with defaults by subsidiaries.

Direct payment obligations

Where a financier relies upon third party credit support which is intended to create an independent or autonomous liability of the issuer, such as a letter of credit or a performance bond, the letter of credit or performance bond will not in all circumstances protect against the insolvency of the borrower. For example, if the borrower performs the obligation the subject of the letter of credit or performance bond while insolvent, the letter of credit or performance bond will expire (because the borrower's obligation has been performed), but a liquidator may require that the benefit received by the borrower be disgorged on the basis of preference under s 588FA of the *Corporations Act*. It is not to the point that the letter of credit or performance bond could have been called upon had the beneficiary chosen to do so.

Many equity bridge facilities are provided on the basis of a letter of credit to support the sponsor's obligation to allow the deferral of an equity investment in the project. If the borrower is insolvent at the time the repayment to the financier is made, then the fact that the financier could have called on the letter of credit or performance bond will not protect the financier against a preference claim. Such a disaster may be avoided by requiring an additional insolvency indemnity from the issuer of the letter of credit or performance bond or by having the letter of credit or performance bond survive any possible preference period or revive if a preference occurs. In many cases, however, this is not practical. As a result, the practice has arisen of structuring letters of credit and performance bonds as "direct pay" obligations which are intended to be drawn against in all circumstances, not merely on the default of the borrower. In effect, the bank providing the letter of credit or performance bond will make the payment and then be indemnified by the borrower. The theory behind direct pay obligations is that it is only a payment made by the borrower which is capable of being preferential, and so an autonomous payment by the solvent issuer of the letter of credit or performance bond could not be capable of being successfully attacked.

In light of the Full Federal Court decision in *Re Emanuel (No 14),*[29] some commentators have suggested that even a payment under a direct pay letter of credit or performance bond could be vulnerable to attack as a preference. In *Re Emanuel (No 14)*, the court focused on the fact that it is the overall transaction which extinguishes the debt in question that constitutes a preference under s 588FA, not the particular payment which extinguishes that debt. In that case, the court held that a transaction is the totality of dealings initiated by the debtor so as to achieve an intended purpose of extinguishing a debt. As a consequence of this

[29] *Re Emanuel (No 14) Pty Ltd (in liq); Macks v Blacklaw & Shadforth Pty Ltd* (1997) 147 ALR 281.

decision, it has been suggested that payment by the issuer of a letter of credit or performance bond could be aggregated with the reimbursement of the issuer by the borrower. Whether the issue is as serious as some commentators apprehend is open to some doubt if the view is taken that any such aggregation of dealings takes into account any security given to the issuer by the borrower over its assets as part of the overall transaction.

In any event, since *Re Emanuel (No 14)*, *Thompson Land Ltd v Lend Lease Shopping Centre Development Pty Ltd*[30] has given some comfort (although based on a predecessor provision to s 588FA). In that case, McDonald J in the Victorian Supreme Court focused on the autonomous nature of the issuer's obligation to the beneficiary. In that case, the issue was whether certain payments made by ANZ by way of bank cheque were dispositions of the insolvent company's property. ANZ argued that each bank cheque was a payment made by ANZ pursuant to its unconditional obligation to Lend Lease as principal under a bank guarantee issued by ANZ and were paid by ANZ out of its funds.

McDonald J noted that irrevocable letters of credit, purchase bonds and bank guarantees were of considerable significance in every day commercial transactions and noted that injunctions to prevent payment under such instruments were very limited. His Honour noted that in taking the bank guarantee, Lend Lease was entitled to rely on the financial strength and integrity of ANZ. It needed to have no concern or regard to the capacity or ability of Thompson Land to honour its contractual obligations with respect to these matters. Lend Lease was entitled to look to ANZ on each of the four occasions for payment from its funds and resources of the moneys comprising the four bank cheques which were in aggregate an amount that ANZ had guaranteed to pay to it pursuant to the bank guarantee.[31] His Honour found that the payment by bank cheque in that case by ANZ was from ANZ's own money not that of the borrower.

Although the issue is not as clear cut as might be liked, commentators now seem to accept that a payment by a bank, of an autonomous obligation (eg, under a bank guarantee, performance bond or letter of credit), is likely to be regarded as independent of the insolvent company's indebtedness.[32] However, as a precaution, it is prudent when acting for a financier which is relying on an instrument such as a letter of credit or performance bond to include, on the face of the instrument, a statement that the issuing bank will pay any claim out of its own funds.

In "greenfield" projects, it is often a requirement that sponsors provide direct pay letters of credit to support their obligation to contribute equity to the project. So, for example, it may be more tax effective for the sponsors to arrange a finance facility to find their equity contribution (often referred to as an equity bridge facility) during the construction period. Sponsor equity will then be contributed upon completion occurring (or earlier if default occurs). This obligation will be

[30] [2000] VSC 108.
[31] Ibid.
[32] See L Aitken, "The Paying Bank and the Preference" (2001) 12(1) JBFLP 51 at 53-55 and P Cornwell, "Project Finance", in *18th Banking Law Conference,* pp 11-14.

supported by direct pay letters of credit. Financiers often require that such letters of credit be issued by OECD banks which have a minimum long-term credit rating of a specified level (eg, AA- or its equivalent) from a recognised ratings agency.

Coupled with this requirement is usually a requirement that such letters of credit be replaced if the issuing bank's credit rating falls below the specified level. Financiers will often seek to retain a discretion as to whether to accept the relevant replacement bank even if it meets the credit rating requirements. The reason usually given for retaining this discretion is that banks have credit exposure limits for other banks – so at the time the replacement letter of credit is to be given, a bank may not, under its internal credit policy, be able to accept more credit exposure to the particular issuing bank. This can be a problem in large banking syndicates as, if one bank is full up on credit exposure to the proposed replacement bank, then it will refuse to accept the proposed replacement letter of credit. There is not a great deal that can be done by sponsors to minimise this risk. However, sponsors should seek to require financiers to act reasonably in relation to the exercise of a discretion to refuse a replacement letter of credit – being full on credit limits to the replacement issuing bank would be an acceptable ground for refusing to accept the replacement issuing bank.

Should a Credit Rating be Considered?

As an alternative to traditional bank debt financing, sponsors may wish to consider other forms of financing (such as capital markets instruments) or may wish to have the project vehicle or its debt rated. In certain financings, the interest rate margin, during the operating phase, may be linked to the project vehicle's credit rating.

What is involved in obtaining a rating? A credit rating assigned by a ratings agency, such as Standard & Poor's, Moody's or Fitch assesses the ability of an issuer to pay principal and interest on the rated debt in full and on time before maturity according to the terms of the debt. Ratings give a basis to compare credit quality in the market. By way of example, long-term debt is rated by Standard & Poor's on a ratings scale of AAA to D- a rating of BBB- or above is considered as investment grade.

The rating process in a project financing will evaluate credit, legal, structural and counterparty risk. A rating can be either public or private – where it is private it is a matter between the issuer and the ratings agency whereas a public rating is for general release into the markets.

The cornerstones of the rating criteria for a structured financing transaction are to assess the bankruptcy remoteness of the project vehicle, the ownership rights (ie, legal title) in respect of the assets and the robustness (ie, creditworthiness) of any third parties which play a role in the structure. Similar criteria can be applied in the context of a project financing transaction. A rating can be attractive for a sponsor which is itself rated where that sponsor may play a key role in the project

financing (ie, such as being the offtaker for all of the product pursuant to an offtake contract with the project vehicle).

Ratings agencies generally prefer to be contacted early in a transaction once a term sheet exists so evaluation of credit risks involved can begin at an early stage. The ratings agency will review the term sheet, identifying strengths and weaknesses of the structure and then discuss these with the investment banker or borrower/project vehicle. Such feedback is particularly valuable in first time transactions because it helps to facilitate the understanding of both parties. Once both parties have a good understanding of the transaction, a formal agreement will be signed between the ratings agency and the borrower/project vehicle – typically the ratings agency will agree to evaluate the credit risks and assign a rating and will receive a ratings fee and an annual surveillance fee.

Once the ratings agency has been engaged, the ratings process commences, Usually the issuer and investment banker will outline the transaction timetable for the transaction including the expected completion of transaction documents and legal opinions – the time taken to complete a rating depends on the depth of analysis required, the quality of the information provided and compiled by the borrower or the investment banker, the focus given by the borrower or the investment banker to the attaining of the rating as well as the characteristics of the relevant market for the product. The rating process is iterative and interactive.

The ratings agency will seek to understand the potential credit risks inherent in the project – this will include risks relating to the jurisdiction in which the project is located (such as regulatory risk) and the market into which the product is to be sold. The ratings agency will also examine the security for the debt and the project documents. The higher the credit rating required, the greater the severity of the stress test of the project's cash flows – the nature of the stress relates to the default and recovery aspects of the project and the timing of cash flows in the structure.

The ratings agency will issue its official rating letter once all documentation is finalised. Once the debt is rated, the ratings agency will monitor the transaction until maturity. The ratings agency will reserve the right to change a rating, should performance not meet expectations.

Market Flex and Material Adverse Change

One final matter which should be noted in this context is the ability of financiers to reprice the project finance facility or indeed to change its structure or terms. So called market flex clauses first appeared in the market in late 1998 in response to crises in global debt markets. They are now commonplace in the United States and to a lesser extent Europe and have found their way into the Australian syndicated loan market.

A market flex clause effectively shifts the risk of market changes from the financiers to the borrower. It does this by reserving to the financiers the right to change the pricing of the facility or the terms or structure of the facility to ensure

successful syndication in response to changes in the domestic or international financial markets. The ability to change pricing means that financiers can increase the interest rate margin and fees charged – the ability to change terms or structure means that financiers can change the covenant package or the structure of the debt (ie, mix of tranches, tenor of tranches and amortisation profile).

These clause are of concern to borrowers as, if financiers exercise rights to flex, this can adversely affect the sponsor's return from the project. Drafted in their broadest terms, these clauses can be open ended as to the quantum of pricing changes, the period during which financiers can flex and the scope of changes to structure or terms. In order to protect themselves, borrowers must seek to impose limits in relation to the exercise of the flex. Limits can be imposed in relation to price changes by negotiating which aspect of the pricing can change (eg, interest rate margin only) and by imposing a cap. The period during which flex can be exercised can be limited by reference to an agreed period (ie, earlier of successful syndication (by reference to final hold positions of joint lead arrangers) and three months after financial close). Flex rights should not allow financiers to reduce the total amount of the debt. Borrowers can also require financiers to give reasons for exercise of flex and require financiers to take into account the impact of flex on the borrower's equity returns.

Generally speaking, the Australian syndicated loan market has been robust and financiers have exercised their rights under such clauses only rarely in Australia.

Another device used by financiers to protect themselves is a clause which gives them the ability not to fund at all if a material adverse change has occurred. Where the material adverse change clause is objective (ie, not expressed to be in the financiers' opinion), whether such an event has occurred will be a question of fact to be determined by a court. If the clause is expressed as a matter for the financiers' opinion, it is likely that courts will require the financiers to have formed their opinion in good faith based on reasonable grounds. Care needs to be exercised by sponsors where such clauses are included – in particular, project risks assumed by financiers (such as market risk) should not be a basis for withholding funding (or indeed exercising default rights) and should be excluded from the scope of the clause.

MANAGEMENT OF SPECIAL RISKS RELATING TO PROJECTS

Process and Design Risk

This is the risk that the technology used in the project may not work or, if it does work, that it may take an unacceptably long time for it to work properly or that it may not do so economically.

This risk is very industry and project specific. For example, most open pit gold mining operations in Australia use straightforward equipment and techniques which have been developed by the gold mining industry over a considerable

period. On the other hand, many of the offshore oil and gas projects in Australia and recent projects in the light metals and chemical industries have pushed the technology envelope and the risk of the project's technology being unsuccessful is very real. In fact, there have been recent projects where technology failure has been an issue or led to litigation.

Technology risk is primarily a function of the novelty or the complexity of the particular project. The extent to which this is an issue for the stakeholders in the project, including financiers, is very much affected by the underlying construction contracts. Construction contracts may take many forms. The prime contractor may, or may not, have design obligations, and may undertake the work either as a principal or as an agent or co-ordinator of the project owner. Each contract must be analysed carefully, as the allocation of responsibility and risk in each contract is dependent on that contract's terms.

Difficult issues for financiers can also arise in relation to so called "process design" risk and the inability to allocate that risk to a single party. There are several major projects currently being undertaken in Australia where the issue of process design has arisen or will arise. "Process design" simply refers to a process whereby an input is converted into (or combined with other inputs and converted into) an output or several outputs. Where a sponsor has developed or has access to a process design, it will contract with a contractor (or one or more contractors) to build the plant so as to give effect to the process design. In this circumstance, an issue may arise if the contractor is prepared to stand behind what it has built (ie, that the plant will function as specified) but is unwilling to stand behind the process design (ie, that the plant will function so as to effectively implement the process). Should this happen, the question arises as to who will stand behind the process design? The answer may lie in a combination of risk mitigants including the sponsor agreeing to stand behind the risk (to a specified level) and insurance coverage.

Technology risk is usually at its highest during the project ramp up phase. This may be dealt with by having full recourse to the borrower or recourse to the sponsors or other creditworthy parties until the technology is demonstrated to be effective over an appropriate period of time.

In this context, it is also worth making some observations about the practice of requiring bank guarantees or performance bonds from construction contractors. These issues were recently considered by the Victorian Court of Appeal in *Anaconda Operations Pty Limited v Fluor Daniel Pty Ltd*.[33] The case was an attempt by the contractor under a building and engineering contract to prevent the enforcement of a bond or the application of its proceeds by the owner. The bonds in question represented 5% of the contract price under a design and construction contract entered into by Fluor Daniel Pty Ltd of a nickel and cobalt extraction plant at Murrin Murrin in Western Australia.

The Court of Appeal confirmed the well understood position that a court would only interfere with payment under such bonds in very limited circumstances

[33] (1999) VSCA 214. Unreported judgment.

noting, however, that the contract itself could regulate when such bonds could be called on. Brooking JA commented:

> "Now it is of course, plain that while, in the absence of fraud known to a bank and possibly some other very special circumstances, a bank which has given a bond in terms like the present ones must pay on demand and is not concerned with the underlying contract between contractor and owner, yet the terms of that contract may be such as to make it wrongful, as between the parties to it, for the owner to make a demand on the bank, and that if this is so, the contractor may seek an injunction to prevent the owner from making the demand. The efficacy of such a contractual restriction is undoubted: *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 VR 420 at 429-30 and cases there cited."[34]

Brooking JA noted that there was no express prohibition or restriction in the design and construction contract on the calling up of the security. In fact, the contract stated that the owner could call upon the security at any time and the contractor would not seek an injunction against the owner or the issuer preventing a demand for payment under the security.

The contractor also asserted that once the security was called upon and cash received by the owner, the cash did not become the owner's money – rather it could only be used for a specific purpose. The Court of Appeal noted that the contract contained an express provision stating that "The owner does not hold any Approved Security or the proceeds of any Approved Security on trust for the Contractor." Whilst the object of the provision of the bonds was to give the owner security in respect of the contractor's obligations under the contract, it was not a necessary or natural implication from this statement of purpose of the security that the proceeds of the converted security were to be impressed with a trust. The court found that the proceeds of conversion became part of the general funds of the owner. To the extent that the design and construction contract imposed obligations on the owner in respect of the proceeds of a call (ie, to repay certain amounts if certain milestones were achieved and pay interest), the court found that these were contractual obligations only – the owner received the proceeds and could apply them as it wished. The court contrasted its wording with provisions often found in such contracts whereby a trust is created or retention moneys or of the proceeds on conversion of the security.

The case highlights the need for project vehicles and sponsors to carefully consider the wording of those provisions of the design and construction contract dealing with performance bonds or retention money and the application of such money. In this regard, Brooking JA noted that the provisions of the contract in the Anaconda case were "unusually simple and, I think, unusually clear" so one could do worse than to use these as a guide.[35]

[34] Ibid at paragraph 8.
[35] Ibid at paragraph 2.

WTO Compliance for Government Support

In connection with major projects, sponsors may be granted financial or other support from either or both of state and federal governments. This support can take the form of a cash grant or the provision of supporting infrastructure for the project.

Australia is a member of the World Trade Organisation (WTO). Accordingly, any government support must not infringe the provisions of the WTO's Agreement on Subsidies and Countervailing Measures (WTO SCM Agreement). In particular, issues may arise as to whether the proposed form of any federal or state government financial assistance provided in connection with a project would be:

- a Prohibited Subsidy under Pt II of the WTO SCM Agreement; or
- an Actionable Subsidy under Pt III of the WTO SCM Agreement; or
- susceptible to the imposition of Countervailing Duties under Pt V of the WTO SCM Agreement.

Definition of subsidy

Article 1.1 of the WTO SCM Agreement specifies the circumstances where a subsidy is deemed to exist. A subsidy exists if:

"(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), ie, where:

(i) a government practice involves a direct transfer of funds (eg grants, loans, and equity infusion), potential direct transfer of funds or liabilities (eg, loan guarantees);

(ii) government revenue that is otherwise due is foregone or not collected (eg fiscal investments such as tax credits);

(iii) a government provides goods or services *other than general infrastructure*, or purchases goods;

(iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments; or

(a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994; and

(b) a benefit is thereby conferred."

Where a government provides infrastructure which is available for general use this does not constitute a subsidy. Therefore, where a government contributes to the development of a project by providing funds which must be applied in the development of infrastructure (such as port facilities or pipelines), this will not constitute a subsidy provided the infrastructure falls within the description

"general infrastructure". General infrastructure is not defined by the WTO SCM Agreement but the better view is that infrastructure developed using government funds will meet the test of general infrastructure provided it is infrastructure which is also available for use by third parties. So, for example, a pipeline to which access was available by third parties under access arrangements which met the requirements of Pt IV of the *Trade Practices Act* should meet the requirements of general infrastructure.

Howe decision and prohibited subsidies

Prohibited export subsidies were recently considered in the *Howe Leather Company* (Howe) decision.[36] This was one of the first cases concerning the application of Pt II, Art 3 of the WTO SCM Agreement to come before a WTO Panel. Howe involved a complaint by the United States in relation to grant and loan money provided by the Federal Government to the company. The United States claimed that these payments were export subsidies in contravention of the WTO SCM Agreement to which both Australia and the United States are signatories as members of the WTO. At the time of the decision, Howe was the only dedicated producer and exporter of automotive leather in Australia.

Article 3.1(a) of the WTO SCM Agreement is in the following terms:

> "… the following subsidies…shall be prohibited:
> (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;"

The financial assistance provided by the Federal Government to Howe took the following forms:

- A loan contract providing for a loan of A$25 million by the Federal Government to Howe. There was no requirement on Howe to pay any principal or interest on the loan for the first five years of the term. After the five-year payment break, the interest rate of the loan would be 2% above the rate for Australian Commonwealth Bonds with a 10-year maturity. The loan was secured by a second charge over the assets and undertakings of Howe's parent company.
- A grant contract between the Federal Government, Howe and its parent company. The grant provided for three payments of up to an aggregate maximum of A$30 million. The terms of the grant were specifically directed at interim and aggregate sales and investment targets. The first payment of A$5 million was made on the signing of the contract. The second and third payments of A$12.5 million each were to be made at specific dates upon receiving satisfactory reports that Howe had achieved the stipulated sales and investment targets.

[36] Australia – Subsidies provided to Producers and Exporters of Automobile Leather, Report of the Panel, WT/DS126/R, 25 May 1999 (99-1888).

The conclusion of the WTO Panel was that the grant payments to Howe constituted a Prohibited Subsidy. The factors which led the Panel to this conclusion were that:

- the domestic market was not sufficient to absorb Howe's levels of output even prior to the grant contract;
- Howe's automotive leather business was plainly export dependent even before the grant contract;
- the sales and investment conditions attached to the grant showed that the money was to support increased export activity;
- the company apparently understood the grant was a subsidy to assist their export efforts; and
- the grants were a direct replacement for other government funding, which, were it still effective, may itself have been found to be contrary to Pt II, Art 3 of the WTO SCM Agreement and therefore a prohibited export subsidy.

However, the WTO Panel also concluded that the loan did not constitute a Prohibited Subsidy. The Panel found that there was not a sufficiently close link between the financial assistance and Howe's present and future export performance. The factors which led the Panel to this conclusion were that:

- nothing in the loan agreement was explicitly linked to Howe's export performance or even its sales and investment performance more generally; and
- the loan agreement was between the government, Howe and its parent company, so the loan could be repaid by Howe's parent company without there being any link with Howe's own automotive leather export performance.

The most important factor for the WTO Panel in Howe when determining whether the assistance came within Art 3.1(a) was the presence or absence of a factual link between the financial assistance and export performance. As far as the loan was concerned, this financial assistance escaped prohibition because it could be properly serviced without any effect on Howe's export performance. The loan could be repaid in full by Howe's parent company. The grant was prohibited because in effect, Howe could do nothing else but increase exports in order to obtain all the available grant money. The absence of anything other than a small and already over-supplied domestic market meant that Howe had no option but to increase exports.

It is interesting to note that the governments of Australia and the United States struggled to reach a negotiated compliance settlement. Australia argued that Howe had no contractual liability to repay the grant or the loan and the government was without any legal remedy to force them to do so and therefore Australia could not comply with the ruling. The US argued that Australia must find a way. Eventually a negotiated settlement was agreed which involved some repayments by Howe over 12 years and a range of government measures.

Therefore, if government assistance is to be provided by way of loan, in order to avoid any WTO issues, the sponsor must ensure that the factors which enabled the WTO Panel in the Howe decision to find that the loan there was not a Prohibited Subsidy, are present in the proposed arrangements for any government support. In particular:

- any loan arrangement should approximate the loan of the type provided to Howe and its parent company – in particular, it should at least be possible that the loan could be paid off in a manner not reliant on the export performance of the project; and
- any financial assistance should be granted on a more general basis than for the specific project alone. The fact that the loan is not being made to the project sponsor but to another entity will assist in this regard.

Financial support structured in this manner should allow a project sponsor the freedom to utilise the money to improve the economics of its project, while manifesting only an indirect link to exports.

Actionable subsidies and countervailing measures

Even if a subsidy is not prohibited under Pt II of the WTO SCM Agreement, it may still be an Actionable Subsidy under Pt III of the WTO SCM Agreement or susceptible to countervailing measures under Pt V. The WTO SCM Agreement makes it clear that these provisions may be invoked in parallel, although only one form of relief (either a countervailing duty, if the requirements of Pt V are met, or a countermeasure under Art 7 in relation to an Actionable Subsidiary) is available.

Countervailing measures generally have more direct consequences to the entity involved. A penalty duty can be imposed on the exported product, often on a provisional basis after only a preliminary hearing with little opportunity for rebuttal by the exporter. In contrast, countermeasures under Art 7 and also under Art 4 for Prohibited Subsidies are generally dealt with on a government to government basis. In the Howe case, the recommendation was that Australia withdraw the subsidies from the company (including those already paid) within 90 days, failing which the US would be entitled to take retaliatory action, for example, against Australian wines and other products.

Whether a non-prohibited subsidy is actionable (because it causes adverse effects to the interests of other member states), or whether a countervailing duty should be imposed is largely a question of factual and economic analysis. It requires proof of injury to the domestic industry or another member country and proof of serious prejudice of that member caused by the use of the subsidy.

Non-actionable subsidies

The WTO SCM Agreement provides that some forms of subsidy which may otherwise be Prohibited or Actionable are specifically Non-Actionable. These

include assistance for certain costs associated with research activities conducted by firms (Art 8.2(a)) and assistance to disadvantaged regions (Art 8.2(b)).

It may be that, where government assistance is to be provided to a project vehicle, part at least of any proposed government support can be structured to fall within one or more of these categories. This is particularly the case where the sponsor has technology which it wishes to further develop for use in the project. Several Australian companies seeking to develop light metals projects have entered into joint venture arrangements recently with the CSIRO to develop technology and some part of the government assistance provided to these companies has been earmarked for this purpose.

Project Insurances and Recent Changes in Insurance Markets

It will be a requirement of project financiers that the project vehicle effect various insurances in connection with the project.

These will generally comprise construction phase insurances such as:

- material damage and advance loss of profits insurance;
- public liability insurance; and
- professional indemnity insurance,

and operational phase insurances such as:

- industrial special risks (including business interruption) insurance; and
- public liability insurance.

In addition, other insurances such as workers compensation, directors' and officers' liability and motor vehicle liability will be required.

Since the terrorist attacks in the United States in September 2001, the global insurance market has been in a state of upheaval – in particular, cover for terrorism risk has been progressively withdrawn by insurance and re-insurance companies.[37] Significant commercial and financial disruption has occurred as a result of the withdrawal of such coverage.

Terrorism exclusions are now invariably included in general insurance policies – if terrorism cover is required, terrorism insurance must be sought and priced

[37] Terrorist risk is difficult to price for insurance purposes. Generally, actuarial models set premiums based on two key factors: the probability of occurrences and the size of the losses. Terrorism represents potentially enormous losses with unpredictable frequency. Inability to address this problem of incomplete information means that insurers and reinsurers face difficulty determining appropriate premiums and writing insurance contracts for this type of risk. However, insurance companies are currently investigating methodologies that could allow them to overcome this problem. The initial impact of this market failure was on the aviation sector. However, the withdrawal of insurance cover for terrorist risk then affected most insurance policies in Australia as existing policies came up for renewal.

separately. Whilst it is possible to purchase such cover, the cost is often prohibitive and uneconomic and therefore not commercially viable. This issue has arisen in a number of recent projects. An assessment then needs to be made of the cost of obtaining such cover against the risk that the particular project is likely to be a terrorist target. With a large pool of assets uninsured for terrorism risk, financiers and investors have been faced with uncertainty potentially delaying commencement of investment projects.

To address a number of concerns in respect of terrorism exclusions, the Federal Government introduced the Terrorism Insurance Bill 2002 – this Bill has now become law in the form of the *Terrorism Insurance Act* 2003 which received Royal Assent on 24 June 2003. The Act establishes the framework to implement the scheme for replacement terrorism insurance (Scheme) announced by the Federal Treasurer on 25 October 2002. The Property Council of Australia and the Australian Bankers' Association supported these arrangements.

Key features of the Act are as follows:

- the Act deems a terrorism exclusion in an *eligible insurance contract* to be of no effect in relation to a loss or liability to the extent to which the loss or liability is an *eligible terrorism loss*. Eligible terrorism loss is a loss or liability from a declared terrorist incident but does not include a loss or liability arising from the hazardous properties of nuclear fuel, nuclear material or nuclear waste;
- eligible insurance contracts are defined as insurance for physical loss or damage to buildings or other structures or works on, in or under land or tangible property contained in or on such property, in each case which is located in Australia and eligible business interruption and public liability insurance cover (whether forming part of a property damage contract or written separately). Other property can be prescribed by regulations. It includes contracts made before the commencement of the Act;
- under s 6 of the Act, a declaration of a terrorist incident can specify a *reduction percentage* applicable to that terrorist incident. A reduction percentage must be specified if the Minister considers that, in the absence of a reduction percentage, the Commonwealth's total liability would be more than $10 billion. Under s 8, if a base amount is payable under a contract because of the terrorism exclusion being void and where the contract was made after 1 October 2003, the insurer is insured with Australian Reinsurance Pool Corporation (ARPC), then the base amount payable by the insurer under the contract is reduced by the reduction percentage;
- the Act establishes a statutory corporation – the ARPC – which will provide reinsurance cover to insurers for loss arising from a declared terrorist incident. ARPC's functions are to provide insurance cover for eligible terrorism losses and other functions prescribed by regulation. It has power to do all things necessary or convenient to perform its functions;

- the Act sets out the circumstances in which the Minister must declare that an act constitutes a declared *terrorist act* for the purposes of the Act – an act can only be declared if it occurs after the startup time (ie, 1 July 2003). The Minister is required to seek advice from the Attorney-General before making such a declaration. The act must have happened in Australia and an act will not be taken into account if the Minister is satisfied that it is an act of war;
- the Treasurer will be able to direct the ARPC on the premiums to be charged for the reinsurance[38] and also as to the extent to which risk is to be retained by the insured under a contract of reinsurance with ARPC;
- the Commonwealth guarantees the due payment of money by ARPC to any other person.[39] The Act contains an appropriation of the Consolidated Revenue Fund to meet the Commonwealth's liabilities under its guarantee and to meet any borrowing by ARPC from the Commonwealth.

The compulsory deeming of terrorism cover was considered to be essential to allow accumulation of a credible pool of funds within a reasonable period – universal terrorism insurance is designed to avoid problems of undiversified risks and uncertainty as to who will be eligible for compensation in the event of a terrorist act.

A transition period, commencing from the Scheme's start up date of 1 July 2003, will apply, as terrorism risk coverage will be deemed into existing contracts without any charges for such coverage being levied until the date of renewal. The ARPC will only collect reinsurance premiums for those eligible insurance contracts entered into on or after 1 October 2003 to give insurers sufficient time to change their systems. In respect of policies entered into during the period from 1 July 2003 to 1 October 2003, reinsurance will be provided by ARPC free of charge[40] in order to avoid forcing a liability onto insurers for which they cannot charge additional premiums to offset the new risk.

The government's objective is to operate the Scheme only while terrorism cover is unavailable commercially on reasonable terms. As a result reviews of the Scheme and the global terrorism risk reinsurance market will be conducted every two to three years, to assess the state of the market and the possible wind up strategy of the Scheme. Components of the Scheme, including pricing, classes of insurance required to provide terrorism risk cover and level of underwriting

[38] Premiums collected from insureds will be paid by insurers to the Scheme in order to fund a $300 million pool and to repay any loan required in the event the claim exceeds the resources of the pool. Insurers will be able to pass these costs on to insureds. Terrorism risk premiums to be charged by insurers to policyholders will not be set by the government – the expectation is that commercial market pressures will ensure that premiums charged to policyholders do not significantly exceed charges for reinsurance.

[39] The Commonwealth's liability was originally proposed to be capped at $10 billion – the cap has been removed. However, as noted above, the Treasurer can declare a pro-rata (percentage) reduction in claims payments by insurers if, otherwise, it is likely that ARPC would be unable to meet all its liabilities to them.

[40] See s 8(4) of the *Terrorism Insurance Act* 2003 in relation to so called *protected contracts*.

available are deliberately flexible, not being set in legislation, in order to encourage the re-emergence of the commercial market.

Other insurances have also become limited in availability. For example, the market for project specific professional indemnity insurance is extremely limited particularly where cover is required for long periods. Few professional indemnity insurers in Australia are currently prepared to underwrite the liabilities of design and construct contractors. Offshore insurers are prepared to provide such cover but only on an "any one claim" basis and cover on an "in the aggregate annually" basis is not available.

Project financiers will require that they (or the security trustee on their behalf) be included in project insurance policies as an insured and may also require that they (or the security trustee on their behalf) be a joint insured along with the project vehicle and sole loss payee. Financiers will also require that:

- the insurer waive any right it may have to set off or counterclaim or to make any other deduction or withholding as against the security trustee and the financiers;
- claims for premiums and other amounts payable by the insured under the policy are waived as against the security trustee and the financiers;
- acts, errors, omissions, misrepresentations and non-disclosure by an individual insured will not prejudice or invalidate the rights of other insureds who are not guilty of that act, error, omission, misrepresentations or non-disclosure; and
- the insurer will not terminate the policy for failure to pay a premium without first giving notice to the financiers and allowing an opportunity to cure the non-payment.

Offtake Risks

Offtake risk for a project vehicle is simply the risk that the project vehicle will be able to sell the product produced from the project in the relevant market. Where the project vehicle will market the product itself directly to customers, this risk is part of the overall project risk. Occasionally, however, particularly where the sponsor makes and markets product on a global basis, the sponsor may wish to utilise a separate company to market the relevant product produced from the project. The project vehicle will contract with the marketing company on the basis that the marketing company will purchase all of the product produced by the project and will pay an agreed price (eg, an average price based on actual sales over a three month period). The marketing company will also agree to ship and store the product pending delivery to customers. The benefit for financiers is that they have a committed offtaker for all of the product (and so do not have to deal with third party customers), they will get access to the marketing expertise of the sponsor and do not have to separately arrange shipping and logistics. The downside is that loss of the offtake contract could leave the project vehicle

exposed in relation to marketing of the product as the project vehicle will have no direct customers and will need to arrange shipping and logistics.

In addition, there are a number of potential insolvency related risks for project financiers to the project vehicle in relation to sponsor offtake arrangements. In relation to offtake arrangements, financiers may be concerned about the impact of:

- the bankruptcy of the proposed offtake entity; or
- the bankruptcy of the sponsor itself,

on the ability of the project vehicle to market product from the project.

These concerns may arise because financiers will usually only have a security interest over the project entity's interest in the offtake contract – financiers will not have a security interest over the assets of the offtake entity. If the offttake entity and/or the sponsor were to become bankrupt, the result could be that the project vehicle, as owner and operator of a financially sound and operating plant, must terminate the offtake contract and then be left with no direct contracts in place to sell the product or ship and store the product.

Legal issues in connection with termination of offtake contract

Such product offtake arrangements may be structured as follows:

- the offtake vehicle will usually be a wholly-owned subsidiary of the sponsor;
- the offtake entity will purchase the product from various subsidiaries of the sponsor (including the project vehicle);
- the offtake entity will sell that product in the relevant markets and account to sellers of the product for an agreed price; and
- the offtake entity may also enter into shipping arrangements with a shipping company.

Place of incorporation of offtake entity

Consideration will need to be given to where the offtake vehicle is to be incorporated as the laws of that jurisdiction will be relevant to various issues. In particular, if the offtake vehicle is incorporated in a jurisdiction outside Australia, issues will arise as to:

- whether that entity would be automatically caught up in the sponsor's bankruptcy if incorporated in the same jurisdiction as the sponsor; and
- the impact of relevant bankruptcy laws if financiers wished to terminate the offtake contract.

Events of default under offtake contract

Financiers are likely to require that the offtake contract:

- contain events of default relating to the offtake vehicle including matters such as failure to pay, breach of material undertaking (other than non-payment), incorrect representations or warranties, cross default under any financial indebtedness, invalidity or illegality of the contract and insolvency events. If the sponsor has guaranteed the performance of the offtake entity, financiers may also require termination events related to the sponsor as performance guarantor. Sponsors should seek to limit these to actual insolvency events affecting the sponsor. In particular, any proposal that the right to terminate be linked to a fall in the sponsor's credit rating should be resisted – as the offtake vehicle is a stand alone marketing vehicle, it may remain a viable company even in the case of a downgrade in sponsor credit rating; and
- contain negative pledge undertakings by the offtake vehicle (eg, not to grant any security interests over its assets).

Financiers may also seek to have the sponsor agree to subordinate any indebtedness of the offtake vehicle to the sponsor (eg, in relation to inter-company loans) to the claims of entities from whom the offtake vehicle has purchased product (which will include the project vehicle).

Termination of offtake contract

If an event of default occurs under the offtake contract, the project vehicle will have the right to terminate that contract. Financiers, in the financing agreement with the project vehicle, will constrain the ability of the project vehicle to exercise its right to terminate the offtake contract if an event of default occurs – they will require that the project vehicle only do this with the consent of the majority financiers.

Is there anything in Australian bankruptcy laws which would prevent the exercise of such rights (ie, prevent the exercise by the project vehicle of a right to terminate the offtake contract as a result of the insolvency of the offtake vehicle)?

Section 301 of the *Bankruptcy Act* 1966 (Cth) provides that a provision in a contract or agreement for the sale of property, to the effect that the contract or agreement is to terminate or may be terminated by the vendor if the purchaser becomes bankrupt, is void. Parts 5.6 and 5.7B of the *Corporations Act* contain a regime dealing with the winding up of companies and the recovery of property or compensation for the benefit of creditors of an insolvent company – this regime does not contain any provision similar to s 301 of the *Bankruptcy Act*. The better view is that the *Corporations Act* regime constitutes a code for the winding up of companies. As it does not contain a provision similar to s 301 of the *Bankruptcy Act*, s 301 does not apply in the winding up of companies but only applies to the winding up of individuals. Australian ISDA documentation is based on this premise. If the offtake vehicle was incorporated in a foreign jurisdiction and the bankruptcy laws of that jurisdiction contain a provision similar to s 301 which can apply in corporate bankruptcies, additional issues may arise as to the ability of financiers to terminate the offtake contract.

Other than where the offtake vehicle has failed to make a payment under the offtake contract, financiers may be reluctant to terminate the offtake contract as they would need to find a replacement party to distribute the product. Also, if the project vehicle were to terminate the offtake contract, financiers may be concerned:

- to ensure that neither marketing vehicle nor sponsor competes for customers in relevant regions and markets. Any undertaking by the sponsor or the offtake vehicle not to compete for customers in various markets may give rise to anti-trust or competition law issues. This would involve an analysis of anti-trust or competition laws, not only in Australia, but also in other relevant jurisdictions where the non-compete covenant was to apply. Based on the laws in Australia, it may be possible to structure a non-compete arrangement whilst both the project vehicle and the offtake vehicle remain wholly-owned subsidiaries of the sponsor and no third parties are involved. However, any such arrangements could not enure for the benefit of any third party purchaser of the project (eg, upon a sale arising out of enforcement by the financiers); and
- to ensure that the offtake vehicle transfers or makes available to the project vehicle suitably qualified and experienced marketing staff of the offtake vehicle.

Multi-User Services Corridor

One topical issue at the moment, particularly in connection with a number of projects on the Burrup Peninsula in Western Australia, is the use of so called multi-user services corridors and the legal issues which arise in respect of such arrangements. A multi-user services corridor is a land corridor, usually owned by government, which government wishes to make available to multiple private sector users so that they can co-locate infrastructure in the corridor (such as pipelines) to provide services to various projects or to allow shipment of product from the project.

A number of legal issues in relation to such arrangements. One important legal issue relates to the potential degree of risk to which a user would be exposed in conducting its operations in the services corridor.

Potential risks which may arise in the corridor would include the following (with potential for any particular type of risk occurring or not occurring varying between different users, but with the potential for risks of some nature occurring being common to all users):

- leaks from pipelines, and the resulting consequences of those leaks; and
- damage to pipelines as a result of activities associated with users in the corridor during construction, operation and maintenance. Examples of this could include damage caused by vehicles, cranes, diggers etc.

Experience suggests that the most likely risk to all users will be from the activities of users in the corridor during works involving either construction or maintenance of the pipeline or system.

One issue to be carefully reviewed by corridor users is:

- how the proposed sublease or licence for the corridor allocates liability, as between lessor and lessee (or licensor and licensee) and other users for any loss or liability or expense; and
- whether liability for loss is limited or unlimited in amount.

If liability is unlimited, the lessee (or licensee) could be exposed to liability for all losses of any nature, whether direct or indirect/consequential – this would include liability for economic loss, such as loss of profit or revenue, as well as liability for damage to person or property. Losses could be substantial having regard to the number of potential corridor users, the available space, the consequential operational environment and the types of industries involved (which may involve shipment of materials which can explode or combust).

Many corporations believe, that as a matter of corporate policy, it is no longer sustainable or good commercial practice to have unlimited liability between parties. For internal risk management purposes, to assist in obtaining insurance and to satisfy financiers, there is a strong argument that each user needs to limit its exposure to the lessor (licensor) and other users. To this end, users of such a services corridor may wish to consider a regime whereby:

- they provide to the lessor (licensor) and other users of the corridor, a reciprocal limitation on liability in the form of a cap on liability and exclusion of some forms of indirect damage and consequential loss; but
- the limitation on liability would only apply to limit a user's liability to the extent that the user has complied with the relevant "best industry practice" and "reasonable and prudent operator" standards.

The rationale for an approach such as this is that one of the best ways to reduce risk and avert potential claims is to establish systems of behaviour directed at reducing the risk of incidents occurring, and thereby creating an environment for safe operations. Arguably, this can be best achieved by ensuring all users have the same obligations regarding the use of "best industry practice" and being "reasonable and prudent operators" in carrying out their various activities in the services corridor. Given the types of industry which will normally be using the corridor, these standards are, or should be, part of normal operating procedures.

Whilst this seems a sensible approach, government may resist any limitations of liability or obligations in relation to behaviour in the service corridor although it will usually require the user to assume an obligation to act in accordance with prudent industry practice. If this occurs, a user may wish to focus on attempting to agree mutual limitations of liability directly with existing or anticipated users of the services corridor.

Tax Risk

Tax risk has become increasingly relevant particularly in "greenfield" infrastructure project financings and privatisation project financings.

Sponsors will seek to structure their involvement in the project in a tax effective way. This may have both an international aspect and a domestic aspect. The international aspect is particularly relevant in the case of a foreign sponsor. A foreign sponsor will wish to structure its ownership interest in the project so that it is tax effective both offshore and onshore. In some cases this may mean that the ownership interest is held indirectly through entities in several foreign jurisdictions so that project distributions (whether in the form of interest or repayment of principal on subordinated loans, dividends or trust or partnership distributions) are received in a tax effective way. For both a foreign or domestic sponsor, the aim will be to use a tax effective project entity. In some cases this may involve the use of a partnership of special purpose vehicles or an unincorporated joint venture (which may be treated as a partnership for tax purposes), neither of which is itself a taxable entity for Australian income tax purposes. This means that profits and losses flow through the vehicle and are taxed in the hands of the partners or joint venturers. This can be contrasted with a company which is a taxable entity and a trust which can be taxed as company in some cases or taxed itself if income is not distributed to beneficiaries.[41] Losses may also be trapped in companies and trusts and not immediately available to the partners or joint venturers.

Tax risk may extend not only to the ownership structure, but also to the financing structure itself. In some transactions, sponsors have sought to structure their project financing arrangements so as to achieve tax benefits not only in Australia but also in a foreign jurisdiction. This is often referred to as a "double dip".

Project financiers have had to come to terms with some complex financing structures in recent years. In some cases, financiers have not been comfortable with taking the tax risk and have sought a sponsor's indemnity for the leakage risk arising from the structure (ie, the risk that a tax liability will arise as a result of the structure which causes the financier to be at risk of not receiving the full amount of the amounts outstanding to it or an unbudgeted taxation liability).

Project financiers have sometimes required tax risk to be managed or mitigated through:

- a tax opinion from the sponsor's tax advisers;
- an independent review of the sponsor's tax opinion; and

[41] For more on the legal structure of the project see above under the heading "The Choice of Project Vehicle" p 101.

- in some cases, a private ruling from the Australian Taxation Office (ATO). (For sponsors, the process of obtaining a private tax ruling from the ATO can be time consuming and can lead to considerable delay in the project timetable).

There have been substantial changes in Australian income tax legislation in recent years. Significant areas of risk for sponsors and project financiers alike include:

(a) s 51AD of the *Income Tax Assessment Act* 1936 (Cth) (ITAA)[42] and Div 16D of the ITAA which can deny tax deductions where government is involved in the project;
(b) the "debt/equity" rules in Div 974 of the *Income Tax Assessment Act* 1997 (Cth) (1997 Tax Act) which determine whether an interest is to be treated as in the nature of debt or equity for tax purposes;
(c) the "thin capitalisation" rules in Div 820 of the 1997 Tax Act which determine the level of debt which a project can carry before deductibility of interest is denied;
(d) the new consolidation regime which allows wholly-owned company groups to consolidate their profits or losses and have only the "head company" of the group pay income tax (subject to transitional relief, the consolidation regime replaces the previous rules for transfer of tax losses within company groups); and
(e) Div 243 of the 1997 Tax Act which can deny tax deductions relating to limited recourse debt.

The risk of a sponsor utilising a project's tax losses under the previous loss transfer rules led project financiers to employ devices such as so called tax subvention deeds or tax indemnity deeds. These are entered into either by the holding company of a relevant group (or in same cases by all members of the company group of which the project vehicle is a member) and require the parent company to indemnify the project vehicle if tax losses are utilised elsewhere in the company group and this causes a tax liability to arise in the project company. With the introduction of the new tax consolidation rules, tax indemnity deeds can be complex particularly where there is a transfer of an ownership interest in the project. In this case, a project vehicle may cease to be a member of one consolidatable group and become a member of another consolidatable group and the tax indemnity deed will seek to ensure that there is no "gap" in financiers' coverage against tax risk. These deeds also need to accommodate the fact that the group of which the project vehicle is a member will be required to enter into a tax sharing agreement (in a form which complies with ATO rules and guidelines). Ensuring that the tax sharing agreement comes into place at the requisite time (ie, before the election to consolidate is made) and that the tax sharing agreement reflects the principles in the tax indemnity deed are matters of concern to financiers. On the other hand, sponsors do not wish to disclose all of the tax affairs of the group to scrutiny by financiers. As in all such matters, an appropriate balance must be negotiated.

[42] Reform of s 51AD and Div 16D is the subject of ongoing consideration by the Federal Government but the government's final position has not been publicly announced.

Finally, as a result of amendments to the interest withholding tax provisions of the ITAA, most project financings are now structured so as to enable offshore financiers to participate in the financing in a manner which does not cause the borrower to be liable to pay Australian interest withholding tax. Traditional syndicated loans are now structured as loan note subscription facilities. These loan notes are intended to constitute debentures for income tax purposes and to be offered by the borrower/issuer in a manner which satisfies the public offer "test" in s 128F of the ITAA. The risk of satisfying the public offer test is shared amongst the borrower/issuer and the joint lend arrangers or syndicate agent (as it is the joint lend arrangers or syndicate agent which controls the syndication process). The joint lend arrangers or syndicate agents will give representations and warranties and undertakings to the borrower/issuer in relation to the manner in which the loan notes are offered to other potential financiers. This gives the borrower/issuer the necessary assurance that one of the limbs of the public offer test in s 128F should be met and that it should not be liable to pay Australian interest withholding tax on interest payments to non-resident financiers. Borrowers also will require an exception from the usual gross up obligation for taxes where the loan notes are held by an "associate", as defined in s 128F, as the withholding tax exemption can be lost in these circumstances.

CONSENT DEEDS

Invariably the project vehicle will enter into one or more project contracts which are essential to the project, such as the concession agreement in an infrastructure financing or a long-term sales contract in a mineral project. A financier of such a project will require that a direct relationship between itself and the counterparty to that contract be established which is achieved through the use of a consent deed (sometimes called a tripartite deed or direct agreement).

The consent deed sets out the circumstances in which the financier may "step in" under the project contract in order to remedy any remediable default or "step into the shoes" of the project vehicle if the default is irremediable. Other security concerns of the financier may also be addressed, for example, by an undertaking from the project vehicle and the contract counterparty that the terms of the key contract will not be amended without the financier's consent.

A consent deed will normally contain:

(a) *acknowledgment of security* – a confirmation by the contract counterparty that it consents to the financier taking security over the relevant contract;

(b) *notice of default* – an obligation on the contract counterparty to notify the financier directly of defaults by the project vehicle under the relevant contract in order to enable the financier to enforce its security or to exercise "step-in" rights to remedy the breach;

(c) *cure rights and extended periods* – an obligation on the contract counterparty to ensure that the financier has sufficient notice to enable it to remedy any

breach by the project vehicle. In some cases, the financier will insist on extended cure periods over and above the cure period available under the contract to the project vehicle itself;

(d) *receivership* – an acknowledgment by the contractor that the appointment of a receiver by the financier is not a default under the relevant contract and that the receiver may continue the project vehicle's performance under the contract notwithstanding liquidation of the borrower;

(e) *sale of asset* – the terms and conditions upon which the financier (or its receiver and manager, agent or attorney) may transfer the project vehicle's entitlements under the relevant contract.

Consent deeds can give rise to a number of issues of concern to the contract counterparty and can lead to difficult negotiations between contract counterparties and financiers. For example, it is sometimes frustrating for a third-party long-term supplier of gas to a power project to be asked to forgo (at least to some extent) rights of termination that the supplier considers perfectly normal and which, paradoxically, the supplier would be able to obtain from purchasers with a far better credit standing than a sole purpose project company.[43]

Sometimes, however, difficulties in negotiations can be due to a lack of understanding of the legal position in relation to consent deeds. Some of these issues are considered below.

Appointment of Receiver and Manager

The rights and obligations conferred on the financier under a consent deed are a crucial part of the financier's security.

If a project vehicle defaults under its security, such as a mortgage over a lease, the financier may wish to enforce the security by appointing a receiver and manager. But for a consent deed which contains a protection against such a consequence, it is highly likely that the appointment of a receiver and manager to the project vehicle would be an event of default under the relevant contract (eg the lease) the subject of the security. This would itself trigger rights on the part of the contract counterparty to the contract (ie, the lessor in the case of a lease), who could retake possession of the lease depriving the financier of the value of its security.

It is for this reason that the financier requires the consent deed to acknowledge that the financier can enforce its rights under its security and that this of itself will not give rise to a right on the part of the contract counterparty to terminate the contract.

Performance of Contract by Financiers or Receivers and Managers

One issue which is of concern to contract counterparties is whether, if a receiver and manager is appointed by the financier to take possession of the property the

[43] G Vinter, *Project Finance* (2nd ed, Sweet & Maxwell, London, 1995), para 5.23.

subject of the relevant project contract, the financier and its receiver and manager should be required to agree to perform all future obligations under the relevant project contract from the date it takes possession?

Financiers and any receiver and manager appointed by them will usually resist any commitment to perform the relevant contract – rather the consent deed will usually provide that the financier has the option, when its security is enforced, as to whether the contract is performed by it or its receiver and manager.

It is helpful for contract counterparties to understand the legal obligations of receivers and managers appointed by financiers. This can be most constructively considered by reference to two categories of contracts – leases and hiring agreements and other contracts.

In regard to leases and hiring agreements, in summary the position is as follows:

(a) receivers who enter into possession of a company's premises as its agent do not thereby become liable for arrears of rent before their appointment.[44] Under the general law, receivers are not even liable for rent for the whole period after possession until the date on which possession is surrendered to the company's landlord, provided they have not accepted personal liability for the rent. If, as agents of the company, the receivers and managers pay the landlord or lessor rent, they do not thereby make themselves a tenant by estoppel and incur a personal liability for the rent;[45]

(b) if receivers and managers adopt the existing lease or assume a personal liability as a guarantor of the company's obligations under the lease, they will become liable;[46]

(c) however, receivers may become personally liable under s 419A of the *Corporations Act*. Under s 419A, receivers and managers may give the owner or lessor of property a notice, within seven days after the control day (as defined in s 9 of the *Corporations Act*), specifying certain property of the owner or lessor which the corporation is using or occupying and stating that the receivers do not propose to exercise rights as receivers and managers in relation to that property. Whilst such a notice is in force, the receivers are not liable for the rent or other amounts payable by the corporation under a lease or hiring agreement with the owner or lessor of the property. The notice ceases to have effect if revoked by notice in writing given by the receivers and managers to the owner or lessor or if the receivers and mangers exercise, or purport to exercise a right in relation to the property as receivers and managers.

    If no notice is given under s 419A(3), receivers and managers have a period of grace of seven days from the control day (as defined in *Corporations Act*, s 9) – during this period, they are not liable for rent or other amounts payable by the corporation under a pre-receivership lease or

[44] *Rangatira Pty Ltd v Viola Hallam Ltd* [1957] NZLR 1188 at 1190.

[45] *Rangatira Pty Ltd v Viola Hallam Ltd* [1957] NZLR 1188; *Re British Investments and Development Co Pty Ltd* (1979) CLC 40-522. See now *Corporations Act* ss 419-419A.

[46] *Titoki Farms Ltd v Lei Jay Catering Ltd* (1987) 3 NZCLC 100,009.

hiring agreement. After expiry of this grace period, receivers and managers will be personally liable for such amounts as long as they continue as receivers and managers and as long as the corporation continues to use or occupy, or to be in possession of, the property of the owner or lessor.[47] This prescribes the extent of their liability under the pre-receivership lease or hiring agreement, and they are not taken to have adopted the lease or agreement simply because they are liable for the rent or other amounts after the grace period expires.

In regard to other contracts, in summary the position is as follows:

(a) under general law, receivers and managers are not personally liable upon any contracts they enter within the scope of their agency during the course of the receivership.[48] Their principal (either the company itself or the charge holder) will be liable on such contracts;[49]

(b) receivers and managers will not be personally liable if they simply complete an existing contract made by the company prior to their appointment – in these cases they are protected by their agency (ie, they are the company's agent). Personal liability can arise if the receivers and managers' agency is terminated by winding up of the company;

(c) even whilst the receivers and managers' agency exists, they can assume personal liability for a contract (eg, by failing to disclose their agency);[50]

(d) receivers and managers are under no obligation to perform trading and commercial contracts entered into by the company prior to their appointment unless a failure to do so would damage the company's goodwill.[51] Provided the company's business reputation is not at stake, receivers and managers may repudiate contracts with virtual impunity.[52] However, a receiver and manager who decides to disregard or ignore a pre-receivership contract must

[47] *Corporations Act*, s 419A(2).

[48] *Goodwin v La Macchia* [1999] NSWSC 1184 (unreported, Sup Ct, NSW, Studdert J, 8 December 1999) (receiver not personally liable for breach of contractual obligation to take out insurance cover for seamen). Unless, of course, they have been guilty of fraudulent misrepresentation in connection with the contract: *Heatly v Newton* (1881) 51 LJ Ch 225. Under *Corporation Act*, s 419, however, receivers and managers are personally liable for debts they incur during the receivership for services rendered, goods purchased or property hired, leased, used or occupied. Moreover, *Lathia v Dronsfield Bros* [1987] BCLC 321 suggests that even under the general law privately-appointed receivers can be liable for a breach of contract by the company when they fail to act bona fide or where they act outside the scope of their authority. However, it is not unconscionable for receivers and managers to accept the benefit of a pre-receivership contract without accepting personal liability to the other party: *McMahon's (Transport) Pty Ltd v Ebbage* [1999] 1 Qd R 185 at 191. But if a party to a pre-receivership contract does not enforce its rights in reliance on a promise by the receivers to perform the contract, the receivers may be estopped from denying personal liability: *McMahon's (Transport) Pty Ltd v Ebbage* [1999] 1 Qd R 185 at 191 (obiter dicta).

[49] See *Gosling v Gaskell* [1897] AC 575 (HL); *Re Vimbos Ltd* [1900] 1 Ch 470 and *Cully v Parsons* [1923] 2 Ch 512.

[50] See *Kettle v Dunster* (1927) 43 TLR 770.

[51] See *George Barker Ltd v Eynon* [1974] 1 WLR 462 at 471; *Re Newdigate Colliery Ltd* [1912] 1 Ch 468.

[52] *Husey v London Electric Supply Corporation* [1902] 1 Ch 411 (CA).

act in good faith and must not act dishonestly or recklessly damage the company's equity of redemption;[53]

(e) if the company in receivership is dependent on the other party to the contract for essential supplies, the receiver's legal right to disregard or ignore the pre-receivership contract will count for little. A creditor may stipulate that no further supplies will be delivered to the company unless its pre-receivership debt is paid in full – this does not amount to economic duress or an abuse of market power although the creditor may be liable to disgorge the payment as an unfair preference in the company's liquidation;[54]

Note that under s 600F of the *Corporations Act*, if receivers and managers of a company request a supplier to provide an essential service (ie, electricity, gas, water or a telecommunication service) to the company, and if the company owes an amount to the supplier in respect of the essential service before the date of the receivers' appointment, the supplier must not refuse to comply with the request for the reason only that the amount is outstanding or make it a condition of the supply of the essential service that the outstanding amount be paid;

(f) doubts remain as to the liability of receivers and mangers in tort. It may be that where receivers and managers deliberately cause a company to repudiate a contract with a third party, they will be liable in tort.[55] However, the better view appears to be that receivers could assert that they had a legal justification for the inducement and that persons cannot be liable for the tort of interference with contractual relations if they act as agents of one of the contracting parties. On this basis, only where receivers have not acted bona fide or where they have acted outside the scope of their authority could they be held liable for procuring a breach of contract by the company;[56] and

(g) under s 419 of the *Corporations Act*, receivers entering into possession of any assets of a corporation, whether as the agent for the corporation concerned or not, for the purpose of enforcing any charge will be liable for debts incurred by them in the course of the receivership for services rendered, goods purchased or property hired, leased, used or occupied. This section cannot be contracted out of but receivers can be reimbursed under any indemnity from the company or any other person.

If the receiver and manager fails to perform the contract, what are the rights of the contract counterparty? The contract counterparty will always have its rights to terminate the contract. In other words, if there is an outstanding default under the contract by the project vehicle which has not been remedied and that default is not cured by the financiers or the receiver and manager within the relevant cure period,

[53] *Re Diesels & Components Pty Ltd (receivers and managers apptd)* (1985) 9 ACLR 825.

[54] *Australian Overseas Telecommunications Corporation Ltd (t/as Telecom Australia) v Russell Kumar & Sons Pty Ltd (receivers & managers apptd) (in liq)* (1992) 10 ACSR 24.

[55] See generally Hueston and Buckley, *Salmond and Hueston on Torts* (20th ed, 1992), pp 357-366 and *Multinail Australia Pty Ltd v Pryda (Aust) Pty Ltd* [2002] QSC 105.

[56] *Lathia v Dronsfield Bros Ltd* [1987] BCLC 321. See also *Said v Butt* [1920] 2 KB 497.

then the contract counterparty will be able to terminate the contract in accordance with its terms.

One sensitive issue is likely to be the length of any additional cure period available to the financiers. Financiers will usually seek to have an additional cure period over and above what is available to the project vehicle under the relevant contract. In the case of:

- well defined defaults (ie, such as a failure to pay money), contract counterparties will often accept a further short cure period to enable financiers sufficient time to consider the default and make the payment; or
- other defaults (such as a failure to perform a non-monetary obligation), this can be more problematic. Financiers often seek lengthy additional cure periods and may even sometimes seek an open ended remedy period as long as they have put forward a cure plan and are "diligently" pursuing a cure. Open-ended cure periods are likely to be unacceptable to most contract counterparties as vagueness and uncertainty should be avoided in termination related clauses.

The length of any additional cure period is often a matter of negotiation but periods of between 30 to 90 days may be acceptable to contract counterparties depending on the nature of the project and the particular default. For example, where the essence of the contract is a payment obligation, then provided payments are being made when due under the contract, a contract counterparty may be relaxed about the length of time to remedy other defaults – on the other hand if there are important non-payment obligations (such as an environmental obligation), the contract counterparty may require a short cure period.

Specific Performance of Counterparty's Obligations under Consent Deed

A concern for a financier is that a court may not specifically enforce the consent deed and may instead award damages for breach of contract (which would be subject to the usual limitations of damages claims, that is, the obligation to prove causation of loss, the need to prove the damage is not too remote, and the need to prove the financier has mitigated its loss to the extent possible).

MI Design Pty Ltd v Dunecar Pty Ltd[57] offers comfort to financiers because the judge in that case, Santow J, showed a willingness to award specific performance of a mere contractual obligation notwithstanding some difficulties. The relevant facts were that a lessor of a hotel retook possession of a lease where the lessee had defaulted under the lease without first providing the financier with notice of the default and the opportunity to cure the default, as required by a deed of consent. Santow J made an order for specific performance of the lessor's obligations, even though it meant reinstating an insolvent lessee. In making this order Santow J observed that if the financier was not given the chance to rectify the breach it

[57] [2000] NSWSC 996

would be at risk of losing the whole benefit of its security and that in these circumstances damages would not be an adequate remedy.[58]

His Honour's comments in relation to the availability of specific performance are instructive:

> "The parties clearly recognise that unless the Bank is given an opportunity to rectify a breach or pay reasonable compensation otherwise for the lessor's damages where reasonably quantifiable, the Bank is at risk of losing the whole benefit of its security. Damages in those circumstances would not be an adequate remedy because the value of that which had been thereby forfeited would be not only difficult of ascertainment but would deny the Bank the opportunity either to leave the existing tenant in occupation or exercise a power of sale, doing so moreover in a situation where the Bank has incomplete knowledge about which option would best suit its commercial interests. Equity would expect the lessor to abide by the negative covenant, not attempt to buy its way out by breaching and then claiming damages would be an adequate remedy …. Clearly enough the negative covenant in cl 17.2 was intended to confer upon the Bank a protection against that very contingency which denial of specific performance would render nugatory….
>
> …Were I wrong in my earlier conclusion that as between lessor and lessee the lessee is entitled to reinstatement it still does not follow that the Bank is disentitled to specific performance because it is seeking ejectment with no standing to do so. On the contrary, what the Bank is doing is simply enforcing a valuable right to have the lessee remain in possession unless the pre-conditions for removal of the tenant are satisfied, as laid down by cl 17 of the Deed of Consent. Thus even if the lessee were not entitled vis a vis the lessor to reinstatement, the Bank has an independent contract with the lessor, to which the lessee is also a party."

Direct Performance Undertaking in Favour of Financiers

Financiers may also seek to include in a consent deed a provision whereby the contract counterparty undertakes directly to the financiers that it will perform its obligations under the contract with the project vehicle. Whilst this may be appropriate where the contract counterparty is related to the project sponsor, in the case of arm's length third parties it may not be appropriate. At the very least, contract counterparties need to understand the different legal risks to which they may be exposed in agreeing to such a provision.

In the absence of a consent deed, the contract counterparty's contractual obligations are owed to the project vehicle not to the financiers. If the contract counterparty fails to perform its obligations under the contract, it would expect to be exposed to a claim by the project vehicle either for damages or possibly for specific performance (ie, where damages would be an inadequate remedy).

[58] See also F Kirkman, "The financier's remedy upon breach of a deed of consent to security – MI Design Pty Ltd v Dunecar Pty Ltd" (2001) 12(2) JPFLP 133.

A provision in a consent deed whereby the contract counterparty undertakes directly to the financiers that it will perform its obligations under the contract with the project vehicle would give financiers either a direct claim against the counterparty for damages for loss suffered by the financiers as a result of the breach of contract or possibly a basis for specific performance. By agreeing to such a provision, the contract counterparty has exposed itself to direct contractual liability to the financiers. This is in addition to any liability it may have to the project vehicle.

If contract counterparties agree to such a provision in a consent deed, they need to ensure that their liability to financiers is no greater than that owed to the project vehicle under the underlying contract. For example:

- if the underlying contract contains a limitation on the amount of loss which can be recovered for a breach of contract (such as a provision which precludes a party recovering indirect or consequential loss) such a provision should also be included in the consent deed; and
- loss which is peculiar to the financiers and not otherwise recoverable by the financiers against the project vehicle should be excluded.

Subordination

In some cases, consent deeds may contain provisions whereby certain payments due from the project vehicle to the contract counterparty under the underlying contract are subordinated to the claims of the financiers against the project vehicle. This provision is often included in consent deeds relating to a D&C Contract where the contract counterparty is both the D&C Contractor and also an equity investor in the project.

Whilst there is a reasonable basis for financiers to argue that abnormal payments (such as a bonus for early completion) be dealt with in this way, normal contract payments (ie, progress claims for work completed) should not be dealt with in this way. The D&C Contractor, even if it is an equity investor in the project, is entitled to payment for work done in the same way as would any other arms' length contractor.

Subcontracts

Consent deeds may contain provisions which require the contract counterparty to ensure that its sub-contracts contain provisions which enable them to be assigned to the financiers (or their receiver) if enforcement rights are exercised by the financiers. Contract counterparties need to ensure that any such obligation is expressed as a reasonable endeavours obligation rather than a mandatory obligation as not all subcontractors may co-operate in this regard.

Equity party consent deeds

Sponsors need to take particular care where consent deeds are required by financiers in relation to the underlying equity investment documents relating to the project (ie, documents such as partnership, joint venture agreements or shareholder agreements or agreements relating to contribution of equity to the project). Consent deeds are often required by financiers in relation to such documents where the project ownership structure is complex (eg, multiple ownership vehicles including partnerships, companies and trusts).

Such consent deeds, to the extent that sponsors are required to give representations and warranties and/or undertakings, can expose sponsors to liability to financiers even where the project financing is on a limited recourse basis. So, for example, if sponsors are required to give representations and warranties in relation to the accuracy of information provided to the financiers, care needs to be taken to ensure that:

- the warranty is worded so as to ensure that it is limited to information actually generated by the sponsors themselves (rather than publicly available information or information provided by a third party);
- appropriate standards of care are applied to information, opinions, projections and forecasts; and
- such warranties are given only at financial close.

The same applies in relation to undertakings given by sponsors (eg, such as an undertaking to maintain a certain level of equity investment in the project for a specified period).

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