PROJECT FINANCING

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INTRODUCTION

The project financing technique has been increasingly utilised in Australia over the past 10 to 15 years and Alan Millhouse's paper is a good summary of some of the important issues which have to be addressed. This commentary aims to give an industry and commercial perspective and briefly highlight some of the practical difficulties associated with project financing, particularly from a borrower's perspective. The commentary concentrates on limited-recourse project financing with particular reference to the resources industry and addresses three main topics: project structuring, finance documentation and lastly securitisation.

In the Australian context the term "project financing" is usually applied to a lending where either the lender's recourse to the corporate assets of the borrower is limited (or more rarely, non-existent) or where the lender's recourse is to a single-purpose company whose only assets are those of the relevant project. At the outset it is important to realise that no two project financings will be exactly the same - they must be tailored to each individual project. They are complex and time-consuming to negotiate and document. From the borrower's perspective they are expensive in terms of Bank fees and margins and also legal and technical consultants' fees. They are also expensive in terms of management time, not only to instigate but in terms of on-going monitoring of compliance. Despite this, borrowers see project financing as a technique by which they can, at a price, have the lenders accept some of the risk associated with construction and operation of a project.

As Alan Millhouse points out in his paper, there are a number of risks to be assessed by a lender when considering whether to undertake a project financing. An additional important preliminary risk often assessed by lenders is "sponsor risk" - that is the financial, management and technical strength of the borrower standing behind the project. Even with healthy projects, lenders may not be prepared to enter into project financings unless the borrower qualifies in terms of certain minimum attributes in this regard. This is so if for no other reason than that in relation to the recourse elements of the financing, the lender will want to know that the borrower can comply with its obligations concerning such things as completion, equity contributions and proper operation of the project.

PROJECT STRUCTURES

The main paper mentions three types of structures - unincorporated joint ventures, incorporated joint ventures and unit trusts. In the resources sector it has, with limited exceptions, been the unincorporated joint venture which has been selected by sponsors as the most appropriate vehicle. This has been not so much because of disadvantages associated with director or shareholder liability with incorporated structures, but because of the income tax advantages associated with co-venturers having direct access to cash flow generated by a project and because co-venturers can adopt different tax treatment of their respective interests in the project. Unit trusts suffer from the residual uncertainty concerning the potential liability of unit holders to indemnify trustees on an unlimited basis.

Also addressed in the main paper is the question of whether unincorporated joint ventures are partnerships. Although there is no direct decision on point, it is submitted that the development and use of such joint ventures, particularly in the resources sector, has now reached such a stage that they are recognised as co-ventures distinct from partnerships, essentially because the co-venturers are not carrying on business in common with a view to **profit**.

If an unincorporated joint venture structure is selected as the most appropriate structure, it is important that the borrowers facilitate the project financing by incorporating appropriate provisions in the joint venture documentation from the outset. For example, the following clauses should be incorporated: permission for security assignment of co-venturers' rights in project - related contracts to their respective lenders; clauses permitting grace periods subsequent to default within which lenders may remedy that default; and clauses in cross charges between co-venturers which contemplate lenders' security rights. On the other hand, lenders must agree to be bound by at least certain provisions of the joint venture documents, such as the provisions governing pre-emptive rights of co-venturers, in circumstances where a lender proposes to sell a defaulter's interest upon enforcement. These areas are usually the subject of lively negotiation, but both sides should be realistic and reasonable in accommodating the other's views.

Whether a special purpose vehicle is incorporated to hold the interests in an unincorporated joint venture will depend to a large extent on the borrower's corporate structure. Both special-purpose vehicle structures and normal operating companies have been used in Australia. Special-purpose companies have an advantage in that they permit easier securitisation of the sponsor's project interest, allow the sponsor to better isolate the project risk, provide slightly better security for lenders in that the parent company can secure the shares in the vehicle in favour of the lenders and lastly, as Alan Millhouse points out in his paper, overcomes some problems associated with liquidation of a sponsor. However, one disadvantage from the sponsor's perspective is that as the special-purpose vehicle's assets will only comprise its interest in the project, lenders will probably require parent guarantees in respect of those financing obligations that are recourse.

PROJECT FINANCE DOCUMENTATION TERMS AND CONDITIONS

In the area of documentation, the key words are flexibility, materiality and balance.

Project financing should aim to achieve a reasonable balance between the need for flexibility on the part of the borrower on the one hand with the need for appropriate lender security on the other hand. The approach often taken by the lender is that the borrower's project discretions and activities should be strictly limited through the use of various "belts and braces" provisions in the finance documentation including representations, warranties and covenants. Both the borrower and lender should focus firstly on what is **important** from the lender's perspective in order to preserve its security and secondly on giving the borrower sufficient discretion to properly operate the project without unduly impinging on that security. Often this will be achieved by introducing concepts of materiality into the borrower's obligations. It is important that both sides negotiate and document terms and conditions very carefully, particularly representations and warranties, covenants and the recourse clauses. Some of the representations and warranties and covenants will usually be given on a full recourse basis (although each project financing will be different). Care should be taken not to cast provisions as representations when they are truly covenants - too often a borrower is requested to give representations which are required to be repeated daily or periodically or worse still are in fact representations as to future events.

Usually a borrower is required to represent as to a number of matters including:

- corporate power and status;
- due authorisation and enforceability of finance documentation and joint venture and project documentation;
- compliance with laws relating to the project and the due issue of necessary Government licences and permits;
- that the main tenures (eg, mining leases) are in full force and effect;
- the absence of litigation involving project assets;
- the financial status of project (and perhaps the borrower);
- the accuracy and completeness of project information given to the lender; and
- that the borrower has good right to charge its project assets.

Some of the more important covenants of the borrower will usually cover the following matters (some of which are mentioned in the main paper):

- proper operation of the project (in accordance with an agreed business plan);
- compliance with and non-alteration of main tenures, project agreements (including sales agreements) and joint venture documents;
- maintenance of adequate and proper insurance;
- compliance with Government licences and permits;
- management of the project;
- borrower's rights of abandonment;
- equity contributions and/or completion obligations of the borrower;
- absence of encumbrances except for lender security (and, if relevant, cross charges);
- rights of disposal of project assets;
- reporting and information supply to the lender; and
- proper use of loan proceeds.

As mentioned above, a balance is required between borrower flexibility and lender security. For example, it is unreasonable to require the borrower to get lender consent to **any** change to a project business plan or completion covenants - material changes only should be focused on as these project ventures are "living" ones and may change in a number of respects during their lives; lenders should not require compliance with **every** obligation in project tenures, project contracts, joint venture documents and government licences - only those obligations the breach of which would have a materially adverse effect on the lender's rights should be focused on and non-material alterations to these should be permitted; the borrower's rights to abandon should be testing but realistic (in order to avoid situations where, despite defaults on repayment having occurred because of project cash flow difficulties and the lender's inability or unwillingness to take action on the default, the borrower cannot meet overly stringent abandonment tests); in the absence of default, the borrower should have the right to dispose of project assets in the ordinary course of business or below some reasonable threshold figure; reporting obligations should be reasonable - that is, at a level that the lender needs - as onerous reporting requirements will unnecessarily divert the borrower's attention from operating the project to compliance with reporting obligations.

Another area which requires close attention in the documentation is the limitation on recourse clause. True non-recourse financing is rare. Usually "limited recourse" is a more apt description - that is, except for certain terms and conditions which are specifically expressed to be recourse, the lending document will specify that the obligations undertaken by the borrower only bind the project assets and that in the event of failure to repay debt, the lender and its receivers and attorneys may only have access to those assets. From the borrower's perspective each obligation which is stated to be full recourse should be examined to ensure the limited recourse nature of the financing remains intact; from the lender's perspective these provisions should be examined to ensure that notwithstanding that repayment of debt is only from project cashflow, appropriate recourse provisions are included to ensure that the project assets are not dissipated or lost. It is not uncommon for the documentation to provide that the following obligations are recourse: operation of the project in accordance with the business plan; material compliance with licences and agreements; equity contributions and/or completion guarantees; absence of encumbrances; disposal of project assets; proper use of loan proceeds; and "clawback" of project cash flow previously paid out to the borrower by way of return on investment. However, as mentioned above no two project financings will be exactly the same and each should be treated individually. Recourse is more complicated where there is more than one borrower and where there is or may be some joint responsibility - for example completion of the project. Each borrower will be particularly interested to ensure it is not jointly liable on a recourse basis except where appropriate. This area should be carefully canvassed in negotiations and documentation.

In larger syndicated financings another area which requires attention is a mechanism to achieve lender consent where such consent is sought by the borrower on certain questions - for example, consent to surrender a lease or change a business plan. Although as Alan Millhouse points out, fiduciary and agency obligations and issues impinge on this area, it is often not practical in these larger financings for the borrower to obtain agreement of **all** banks - sometimes lower thresholds, such as a majority consent, are provided for. If no such mechanism is included, less flexibility is afforded to the borrower which can then result in sub-optimal project performance. Indeed, lenders with smaller commitments may use this to frustrate and to achieve their own ends.

Added complexity will arise in project financings if co-venturers in an unincorporated joint venture finance their project interests separately from different lenders or severally from the same lenders. Care needs to be taken, particularly on the borrower's part, to ensure that the several or separate nature of the borrowing remains in tact so that default by one co-venturer does not automatically cross default to the other. However, by the very nature of the fact that only one project is being financed, a default which is related to the project as a whole (for example, loss of a material tenure or government permit or a materially adverse change to a business plan) will of necessity be a default under each financing or at least cause cross-default. Consequently, the lender and borrower should clearly address in the documentation, those matters outside a particular borrower's control which affect the project as a whole but which can still result in a default for that borrower.

Other areas which require close attention in the documentation include: clearly stated requirements as to project completion, an area where the borrower will be seeking objectivity and the lender will be seeking some discretion; use of independent experts (for example in respect of completion obligations, compliance with business plans or insurance requirements) where the borrower and perhaps the lender should consider mechanisms to challenge expert's reports; "clawback" by the lender of monies paid to the borrower by way of return of investment, in circumstances where subsequent cash flow is not sufficient to service all the project obligations; and lastly the areas of force majeure and/or frustration of contract, where there should be a clear definition of risks accepted by lender and borrower respectively.

Finally, on the question of default, a balance needs to be struck between the competing interests of lender and borrower. The lender's legitimate interests should be catered for in such areas as non-payment of principal and interest or allowing competing encumbrances to be created over project assets. But it is also important to avoid "hair-trigger" defaults - materiality needs to be built into the non-money defaults. For example, it is not in the interests of either the borrower or the lender, to create a default consisting of failure to deliver a regular project report on time, or failure to comply with a minor government licence or permit, or failure to renew a non-material project agreement. Each default clause needs to be examined to see whether it is possible to introduce materiality and/or grace periods. Again where there is more than one borrower, the issue of severality needs to be addressed. It may well be that two sets of defaults need to be created, one set which relates to each borrower severally and a second set which relates to the project (which in effect results in a default for all borrowers). The main paper mentions cross-default from a co- venturer's financing. Cross-default should be limited to those where the project as a whole is affected.

SECURITY

Securitisation of a borrower's unincorporated joint venture assets is complicated and requires in-depth analysis by lender and borrower. From the lender's perspective it will want to ensure that all project assets are properly secured and from the borrower's perspective it will want to ensure that no non-project assets are caught up in the charge.

In a resource joint venture, the security will usually take the form of a charge (and where appropriate a mortgage) over project assets and will usually include:

- a mortgage over real property or other important tenure;
- a security assignment of the borrower's rights under agreements related to the project (including sales agreements and infrastructure agreements);
- a charge over shares in project companies (where appropriate);
- a charge over insurance policy proceeds;

- a security interest in bank accounts which hold project cash flow; and
- a floating charge over the balance of assets (including tangible assets).

A number of issues need to be addressed by lender and borrower. Whilst the lender will prefer that as far as possible a fixed charge be granted the borrower will for obvious reasons prefer a floating charge. As Alan Millhouse mentions, there are more problems with a floating charge from the lender's perspective, however a reasonable balance must again be struck between the competing interests of borrower and lender as in the absence of default it is not appropriate to unreasonably restrict the borrower's rights to deal with project assets in the normal course of operating the project. Where at all possible a floating charge should be preferred so that the borrower does not have to approach the lender for permission to dispose of assets in these circumstances.

The priority of the lender's security over cross-charges (or vice versa) is usually another area for lively debate and requires careful attention. Again the lender should be cognisant of the fact that borrowers have a legitimate interest in seeking a cross charge to protect the integrity of the project should a co-venturer default on its joint venture responsibilities. This area requires careful documentation and solutions vary from project to project. Some lenders may be prepared to allow full priority to the cross-charge; others may allow priority on payment, but reserve the decision as to timing of enforcement to themselves. Too often though, lenders fail to give due cognisance to co-venturers' legitimate interests on the cross-charge issue, which can lead to some friction in negotiation.

Outright assignments by a borrower of its rights under project related agreements are not usual - normally, a security assignment is given. On the issue of security assignments, the lender should be aware that counterparties to the various project agreements to which the borrower is a party (including sales agreements and perhaps Government franchise agreements) may be particularly concerned to see that their relationship with the borrower is preserved with as little interference from the lender as possible. Often counterparties, particularly overseas ones, will be reluctant to agree **in advance** to deal with an enforcing lender - they often do not understand the nice subtleties of security assignments. Lenders should be sensitive to this issue and not make unrealistic requests in respect of security assignment provisions. Undue emphasis on this by the lender may detrimentally affect relationships between the borrower and its customers. The main paper mentions the issue of state agreements and securitisation of the borrower's interests therein. The writer's experience in Queensland has been that the Crown will only permit **security** assignments in favour of lenders and that it will not consent **in advance** to an outright assignment to a third party purchaser upon the lender's sale under its enforcement rights. Further, whilst entrenchment of State agreements into legislative form provides both borrower and lender with some additional comfort, as Alan Millhouse points out, Parliament cannot fetter its future legislative prerogative.[1] The lender should also be aware that whilst product sales agreements may be a major part of its security package, custom and practice may dictate that the binding nature of the agreement (particularly international commodity sales agreements) may not be all that it could be under our contract law, as buyers may place more emphasis on the relationship rather than just the written terms of contract. Sensitivity is again required in this area so that unrealistic requests on securitisation are not made. On the other hand the borrower needs to facilitate securitisation as much as possible. It should, at an early stage, address with its counterparties the issue of security assignment and make provision for this in the assignment clause and also perhaps allow grace periods after breach within which the lender can elect to rectify. Lastly, on the subject of project and joint venture agreements, the lender needs to realise that whilst it may take a security assignment of the borrower's rights under contracts and agreements it must also submit itself to certain obligations therein at least in the enforcement phase. This is particularly so in such areas as the pre-emptive rights clauses in joint venture agreements.

Finally, letters of comfort have, in view of recent cases, become a minefield for the borrower. All parties should specifically address their attention to the issues of whether these letters are intended to create legally binding obligations and if so to what extent (if any) they are intended to override other documentation. The outcome should be recorded in the letter itself. Resolution of these issues will serve to narrow areas of future dispute.

CONCLUSION

Of necessity this commentary is only a brief overview of some of the issues involved in limited recourse project financing, a method of financing which will continue to be a popular method by which borrowers can raise monies for projects. However this method of financing will, given the recent levels of insolvency and the current recession and its effects, perhaps be increasingly restricted to larger projects that have strong cash flow and are backed by reputable and experienced borrowers.

In the area of negotiation of documentation, both lender's and borrower's interests should be served by utilisation of language that gives flexibility and provides for materiality and a balance of interests.

FOOTNOTES

1. There is a lot of useful material in the Australian Mining and Petroleum Law Association's annual conference papers concerning the shortcomings, enforceability and entrenchment of State agreements.