PROJECT FINANCING

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I would like to compliment Alan Millhouse on his most comprehensive and valuable paper. For my part, I propose to concentrate on a number of miscellaneous points which have occurred to me on reading his paper, from the particular perspective of the financing of mining projects structured as unincorporated joint ventures.

PARTNERSHIP VERSUS JOINT VENTURE

As Alan points out, the received wisdom is that mining projects which are so structured are true joint ventures, and not partnerships, because, amongst other things, the venturers do not carry on business in common. Whilst the venturers' activities commence with an asset owned as tenants in common (the ore body) and involve activities carried out in common (the carrying on of mining activities by the project manager as agent for the joint venturers) the venturers take mine output in kind, separately dispose of it, and derive individual profits from so doing. He contrasts this with a property joint venture which, as he says, does not normally involve any taking in kind. There is also a third type of unincorporated joint venture, one for the processing of products from, say, mining operations, such as an alumina refinery or smelter. The venturers' activities do not even commence with assets held as tenants in common. Individual venturers separately purchase the relevant feed stock, which is then processed through a plant owned by the venturers as tenants in common. In other words, there is separate buying, as well as separate selling, even if the feed stock is purchased from a single seller and is shipped on a commingled basis, just as the finished product may be sold to a single purchaser and shipped to it on a similar basis. In such a case it seems to me that the arguments against the venture being in reality a partnership, with all its undesired consequences, may be even stronger than in the case of a mining project.

PROJECT COVENANTS - LEASING

Alan lists a number of typical covenants required of borrowers in project finance documentation. He also points out, quite correctly, that the nature of the covenants must be dictated by the nature of the project. In addition to the matters listed by Alan, lenders should focus particularly on the question of leasing. If the joint venturers are free to acquire vital equipment on lease (such as a dragline in the case of a coal project) the lenders may find that in a default situation the lessor will be free to remove the equipment and leave the project incapable of operation, at least for a considerable period of time. In this regard, operating leases could be as significant as financing leases. The real issues are the degree to which the particular equipment is critical to the project, and the speed with which it can be replaced. For this reason borrowers should be constrained from taking significant equipment on lease, or arrangements made with the lessors in question to ensure the continued availability of the equipment post-default. The latter may prove difficult. In this context it is interesting that proposed s440D of the Corporate Law Reform Bill will preclude a lessor of property possessed by a company taking possession of it during the period of administration. Proposed s444F(1) will also permit a court to order such a lessor not to take possession of the property in question during the term of a deed of company arrangement entered into following an administration.

JOINT AND SEVERAL FINANCING

As Alan points out, lenders will prefer to structure a project financing on a joint rather than several basis. In this context, it seems to me to be worth differentiating two situations. The first is where each individual venturer borrows its participating percentage of the funds to be raised for the project from a single lender or group of lenders, and charges its project assets to secure the borrowings of all venturers, ie, a "joint and several" borrowing. This would not normally be commercially acceptable to the venturers.

The other concept of "joint financing" still involves all venturers borrowing from a single lender or group of lenders. However, each venturer is personally liable, subject to any agreed limits on recourse, only for its own borrowings, and grants security over its project interest only to secure its borrowings. In other words, the relevant distinction is between all venturers choosing, as a commercial matter, to borrow on a project basis from a single lender or lending group, and the different venturers funding their share of the cost of the project in different ways. In the latter case, some venturers could borrow on a project basis (even from different lenders), others could borrow on a "full recourse" or "corporate" basis, and others could fund their share of the project costs from their own internal sources.

Having said that, I certainly agree with Alan that it is much simpler if all venturers do borrow from a single source. Apart from the important technical matters which Alan mentions, each venturer will then have the same incentive to meet the lenders' requirements as to the form of the joint venture agreement and the priority arrangements, as discussed in Alan's paper. If, on the other hand, there are one or more venturers outside the financing they will normally have little incentive to meet those requirements. Nevertheless a number of project loans have been made to a single venturer.

The problem will be exacerbated if a non-borrowing venturer is the manager of the project. The lenders will, in making their credit assessment, set great store on the proved capacity of the manager to manage the project, and will be concerned to ensure that that organisation continue as manager throughout the life of the loan. The borrower may agree with the lenders to use its best endeavours to prevent retirement or replacement of the manager under the joint venture arrangements, but may not have the contractual power to ensure this. Even if a change in the manager without the lenders' consent is an event of default entitling the lenders to call up the loan and enforce its security, this will have little effect on the decision making processes of parties which have not borrowed. Even if the manager does not change, the management arrangements will often confer on it substantial discretions with which the borrower cannot interfere.

PROJECT INFRASTRUCTURE DOCUMENTS - HEDGES

I agree entirely with Alan's statement that the lenders must be satisfied with the extent to which major project infrastructure documents will remain on foot and unaltered during the term of the financing, in particular whilst the lenders are enforcing their security following a default. In this regard, swaps, hedges and other contracts for risk management products may be regarded by the lenders as essential to preserve the cash flow needed for debt service. For example, the lenders may require a borrower for a gold project to maintain a certain minimum level of forward sales so as to minimise price risk. Typically, counterparties under such arrangements may terminate them if, for example, the lenders enforce their security over the borrower's project assets. This is precisely when the lenders want the arrangements to stay in place. One way of overcoming the problem at a commercial level may be to have the counterparty agree with the lenders that, in case of default, the lenders will have an opportunity to decide whether to accept personal liability under the arrangement, in which event the arrangement cannot be terminated in consequence of the default.

The other side of the coin is that the counterparty may be unhappy with the thought that the borrowing venture will be charging all its assets, or all its project assets, thus effectively postponing the counterparty's unsecured claims against it; compare the situation in which the venturer has granted no security over its assets, so that all its creditors rank equally. In this situation consideration may need to be given to allowing counterparties under essential hedges to share, possibly to a limited degree, in the project security.

RANKING OF CROSS CHARGES

As Alan points out, lenders will normally permit the cross charges, given by each venturer to the others to secure its obligations under the joint venture arrangements, to rank ahead of the lenders' charges, at least in terms of monetary priority, on the basis that the cash flow available to a defaulting joint venturer from the project must be first made available to meet the defaulter's share of project operating costs and thus keep the project going. I agree that such priority is only appropriate if it is limited to joint venture obligations. However, it may not be appropriate to extend the priority to **all** joint venture obligations. If the joint venture agreement contemplates expenditure on an expansion of the project which was not taken into account as part of the lenders' initial credit assessment, the lenders would obviously not wish the proceeds of realisation of their security to be applied in satisfaction of obligations of the defaulter to fund the expansion in priority to debt service. Also, query the position of a very large uninsured claim by a third party against the project manager for environmental damage. It would be normal (assuming that the claim did not arise from the manager's gross negligence or wilful default) for such a claim to be borne by the joint venturers under the joint venture arrangements in their participating percentages and thus be secured by the cross charges, and yet the lenders might be most unhappy to find themselves postponed in this situation. The matter is obviously one for compromise, and stresses the desirability of a "joint" borrowing in the sense used by Alan.

PROJECT AGREEMENTS RESTRICTION ON ASSIGNMENT

Alan points out that, ideally, lenders should seek from other parties to major project agreements consent, not only to the granting of security by the borrowers, but also consent to the sale of the mortgaged property pursuant to the security. The latter may be difficult to obtain in practice, particularly if the agreement is of a nature where the identity of each party is of concern to the other. A purchaser under a long term sales contract may be prepared to consent to the grant of security, because that does not of itself mean that it will be compelled to deal with a different party in the future. However, it may be most reluctant to give a consent in advance which could force it to deal with an as yet unidentified purchaser under the security. The purchaser could even turn out to be a competitor.

COMPLETION COVENANTS

As Alan points out, lenders will typically leave "completion risk" with the project sponsors. They will require recourse to the borrower and, as appropriate, its parent, until the meeting of an elaborate completion test, designed to satisfy the lenders that the project has truly been completed in physical, economic, environmental and other senses. As he says, a parent company guarantee of the debt, falling away once completion is achieved, is clearly to be preferred over a letter of comfort, with the associated doubts as to its legal enforceability. An alternative approach which is sometimes adopted is a legally binding undertaking by the parent to ensure that completion occurs by a specified date. Such an undertaking, whilst also better than an unenforceable letter of comfort, is much less satisfactory than a financial guarantee. The lenders' only remedy in the event of breach of such an undertaking will presumably be for damages equal to the loss they have suffered in consequence of the failure to complete. At the least, this would involve them proving either that they have exhausted all their security rights in relation to the project itself, or that any such rights which had not been exhausted were of no value. This is something which they would not have to do in the case of a properly drawn financial guarantee, and could involve substantial delay.

RECEIVER AND MORTGAGEES IN POSSESSION

If the Corporate Law Reform Bill becomes law, as a general proposition the only secured creditor which will be able to commence to enforce its security during a period of administration will be one which has security over the whole, or substantially the whole, of the company's assets. It obviously follows that it will be much less desirable for lenders to make project loans to companies with non-project assets without taking security over the other assets (as they have done in the past). The only alternative may be to move the other assets out to another group company, which could have adverse stamp duty and other consequences.

BILLS OF SALE LEGISLATION

As mentioned in the paper, the Queensland case of **Re Bauer Securities Pty Ltd & Anor**[1] decided that failure by a company chargor to comply with the formal requirements of the Queensland Bills of Sale legislation rendered the charge invalid against third parties, and that neither registration under the Bills of Sale legislation nor registration under the predecessor to the Corporations Law cured the invalidity. I agree with Alan that, until the decision is reversed by legislation, the impact of the decision for project financing in Queensland could be significant, since it will be practically very difficult to comply with the formal requirements of the Bills of Sale legislation. The bill of sale must contain a general description of the chattels or types of chattels comprised in the charge and a description of the place where such chattels are situated or intended to be situated at the time of execution of the charge.[2] In addition any defeasance, condition or declaration of trust to which a bill of sale is subject must be written on the same paper as the bill of sale, unless the date, names of parties and short particulars of the document affected are set out in the bill or a schedule.[3] Such "conditions" probably include all conditions which hamper, modify or restrict the title or remedies of either party.[4]

On the other hand the problem in other States does not appear to be so severe. The Western Australian Bills of Sale Act 1899 is confined to stock, wool or growing crops (which is not relevant for present purposes). The New South Wales, Northern Territory and Tasmanian legislation also requires defeasances, conditions or declarations of trust to which a bill of sale are subject to be written on the same paper as the bills.[5] Nevertheless the requirement in these jurisdictions is not a "stand alone" one which operates independently of registration. In these jurisdictions non-compliance results in the bill of sale being void as if it had not been registered. There seems a good argument that ss273(2) and (3) of the Corporations Law will in fact operate to validate any charge which fails to comply with such a requirement, because s273 gives any charge registrable under the Corporations Law the benefits of due registration under the relevant State or Territory law.

It may also be worth mentioning that the **Re Bauer Securities** problem will not exist in Queensland if the relevant security document is a "debenture", which was held to be the case in **Re Bauer Securities** itself. It seems that an all moneys fixed and floating charge will not usually be a debenture at common law or for the purposes of the Queensland Act. In particular, where the security simply secures the performance of contractual obligations, as in a typical cross charge, the debenture exception will be of no assistance.

Also, in the light of **Broad v Commissioner of Stamp Duties**[6] there must, it seems to me, be some doubt whether a document can be a debenture unless the debt to which it relates is quantified at the date of its creation. There has been a suggestion that it is possible to make an instrument a "debenture" by including a specific acknowledgement if indebtedness of a nominal amount, although again I am not sure that this approach would succeed.[7]

FOOTNOTES

1. (1990) 8 ACLC 230.

2. Bills of Sale and Other Instruments Act 1955-1986 (Qld) s19.

3. *Ibid*, s22.

4. Sykes, **The Law of Securities**, (4th Edition), Section 79.

5. Bills of Sale Act 1898 (NSW) s9; Instruments Act (NT) s10; Bills of Sale Act 1900 (Tas) s7.

6. [1980] 2 NSWLR 40.

7. See **Topham v Greenside Glazed Fire-Brick Company** (1887) 37 Ch 381.