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SESSION 6
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Project Finance

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Paper available for collection after presentation

Project Finance

The theme for this year's conference is the changing nature of financial services. Project finance, particularly in Australia, is a mature sector of the finance industry and has been going strong for over a quarter of a century. The basic techniques involved, and principal legal issues arising, have been well explained and analysed in earlier conferences, most notably by the Chairman's comprehensive paper given in 1992[1]. However, the types of project financed, and the techniques used, have been subject to constant change. So for this paper the author proposes to make some preliminary comments on the evolution of project finance and then to focus on a number of key issues which still require particular attention and analysis in current deals.

Trends

The first project financings in Australia were resources based, and were exclusively funded by syndicated bank loans.[2] The mid 1980s saw project finance extended to processing ventures[3] and some structured infrastructure projects like Eraring Power Station and the Sydney Harbour Tunnel. The 1990s saw a major branching out of project finance techniques, extending them to infrastructure projects, the acquisition (on privatisation) of government owned utility businesses and property finance.

Initially the construction phase risks were covered by sponsor completion guarantees. These were hotly contested, were they guarantees of completion, or guarantees until completion? The doctrine of penalties posed perils to those who sought to formulate hybrids by way of compromise.[4] This debate has now largely gone away, with sponsors becoming more risk averse, limiting their exposure to a

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[1] *Project Financing*, Alan Millhouse, 1992 Banking Law and Practice Conference, Page 345.

[2] See, for example, the early coal mine financings in Queensland, beginning with Oakey Creek (1981), and including Blair Athol, Newlands-Collinsville and Tarong.

[3] Eg the Cooljarloo or Ti-West mineral sands/titanium dioxide project and the North West Shelf LNG venture.

back-ended equity commitment.[5] Most construction phase risks now rest with a head contractor, with residual risks falling on equity and the banks. A number of deals have been done without, even, a head contractor wrap. [6]

Although syndicated bank debt remained the dominant form of project finance in the 1990s, the sheer scale of transactions coming to the markets and the shrinking of bank numbers through mergers and, in some cases, positive decisions not to participate in project finance, meant that the wider capital markets had to be tapped. Projects like the Sydney Harbour Tunnel, the M2 Motorway in Sydney and the Melbourne City Link were part funded by the issue of CPI indexed bonds (but with the banks taking pre-completion credit risk).

The pressure on funding sources exerted by the Victorian electricity privatisations, and competitive bidding strategies which sought to maximise non-equity funding, saw the development in the mid '90s of a mezzanine or subordinated debt tranche, sitting uncomfortably between the senior banks and equity. Mezzanine debt has also now been used in greenfields projects, such as the Melbourne City Link Exhibition Street Extension Project and the recently closed Alice Springs to Darwin Railway.

The most recent wave of privatisations in South Australia (and resales and refinancings of privatised assets in Victoria) has prompted the use of short term bank bridging facilities designed to be taken out by bond or note issues, with those issues in turn enhanced by a "credit wrap". This involves the provision by a AAA rated US monoline insurer of a financial guarantee which brings the bonds involved up from a low investment grade rating to a AAA rating, with the credit wrap fees being something less than the spread between the wrapped and unwrapped credit margins.[7]

Projects involving the production of commodities typically priced in US dollars have also looked to the US capital markets for funding, with bonds issued under Rule 144A of the US Securities Act. This has been notably the case in the lateritic

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[4] Eg, "the Sponsor will ensure Completion occurs by X date. If Completion doesn't occur by that date, the Sponsor will pay the Borrower an amount sufficient to repay its bank debt."

[5] And, on some limited occasions, a contingent equity commitment to provide additional cover during ramp-up, as in the Alice-Darwin Railway and Stanwell Magnesium projects.

[6] For example, Visy's Tumut Pulp and Paper Mill and the Stanwell Magnesium Project.

[7] See, for example, the ETSA refinancing and the financing of SPI PowerNet.

nickel sector though with notoriously mixed results. This funding development was helped made possible by the willingness of US investors to take construction risk, even with unproven technology.

A recent development on the bank funding front, which has quickly become the norm, has been the repackaging of such funding in the form of loan notes with a view to qualifying for exemption under s128F of the Income Tax Assessment Act to enable offshore syndication without incurring a withholding tax penalty.

As noted earlier, bank dominance of project finance may be jeopardised by the sheer contraction of the number of major players in the project finance market.[8] Jay Worenklein of Société Générale views the introduction of mark to market portfolio measurement in bank capital adequacy rules as a major threat to the project finance market. The reason, of course, is that project financings are traditionally illiquid (ie rarely traded) and are typically funded on the basis of a long term view, particularly in commodity markets. The risk of having to mark down portfolios of project loans due to their poor liquidity will provide a further disincentive for banks to participate in this market.

On the local scene business has been brisk. Infrastructure is expected to provide particularly strong growth. Inspired by the apparent success of the concept in the UK[9], state and federal governments are brushing up their policies with a view to encouraging a new wave of "public private partnerships" in the infrastructure sector.[10] This renewal of interest in what used to be called BOOTs leads nicely into the first topic for analysis.

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[8] One commentator has suggested that there are only 8-10 potential lead banks for project finance deals left in the world – Jay Worenklein, Global Head of Project Finance at Société Générale. See *Project Finance International*, April 4, 2001, Page 2.

[9] The Private Finance Initiative (PFI), as it was called in the UK, was launched in the early 1990s and since then more than 400 transactions with an aggregate value of approximately £19 bn have been completed. New transactions are closing at the rate of 30-40 per year. See *Project Finance International*, May 16, 2001, pp 68-70.

[10] In early 2001 draft guidelines for "Partnership Victoria" have been released by the Victorian government for public feedback and the New South Wales government has published a green paper "Working with Government – Private Financing of Infrastructure and Certain Government Services in New South Wales" for comment.

Forfeiture provisions in government concessions

The typical infrastructure project involves the grant of a long term concession, being essentially the right to use or operate a facility (often after first having built it), coupled with a long term lease of the land on which the facility is, or is to be, situated. On expiry or termination of the concession, the facility usually reverts to government ownership. Although compensation may be payable on termination for default by the grantor of the concession, or in the case of certain special early termination rights, it is sometimes not payable in the case of default by the concession holder, even though very substantial investment is usually required by the private sector in building the infrastructure on government land.

The issue of compensation for early termination has also been raised in acute form by a number of privatisations structured in the form of long term leases, usually with a large premium or non-refundable prepayment of rent in advance.

The concession documents are usually prepared by the Government, and typically presented to the private sector in a competitive tender, where deviations will be marked down. So normally the private sector will only have limited bargaining power. Many a first draft has included detailed and onerous obligations on the private sector vehicle, coupled with stringent termination provisions for default by the private sector (rarely qualified by materiality or cure opportunities), with forfeiture without compensation being the ultimate sanction.

It will not surprise this audience that the typical private sector response has been that such provisions are unbankable. Heated and lengthy debates have then followed, leading to a wide variety of solutions.

It is dangerous to generalise, and every project must be considered in the light of its own particular circumstances, including the nature of the obligations the breach of which can lead to termination, and the overall likelihood of breach. That said, the precedents tend to fall into one of two categories.

1. Road and some rail projects

In toll road transactions such as the Melbourne City Link project and the various Sydney toll road projects, the level of obligations, at least post-completion, tends to be relatively light handed (with pre-completion

obligations parcelled off to substantial head contractors), and the risk of default is also low. The termination regime, once fully negotiated, is usually fairly "soft", offering very extensive multi-stage cure arrangements (warnings, discussion about appropriate cure programs, reference of disputes to experts and so on), with the banks being given their own supplementary cure rights, which only commence once the borrower's rights are exhausted.

Essentially, so long as some attempt is being made to fix the problem, the cure procedure can go on for many months, if not years. However, at the end of that process (or on earlier abandonment), the concession can be terminated without any provision for payment of compensation.

This approach has been (reluctantly) accepted by banking syndicates only on the basis that they have been satisfied that the default and cure provisions are such that there is no realistically foreseeable circumstance where they could not prevent termination of the concession by undertaking some cure activities. In this context, it is important to note the relative simplicity of a toll road as an operating asset, and the existence in the related Concession Deeds of protections in relation to material adverse changes in the circumstances of the relevant toll road, and force majeure relief.

The above approach was also adopted in relation to the Brisbane Airport Light Rail (Airtrain) project, and for the Alice Springs to Darwin Railway. It is also the regime that applies, after completion of construction, to the Olympic Stadium. This position has also been adopted for most motorway projects in the UK.

2. Airports and South Australian Electricity Privatisations

In the privatisation of Australia's international airports, the Commonwealth Government provided only severely truncated cure opportunities in relation to termination events, but those events were limited to serious events, such as loss of the relevant licence. This was further tempered by a provision negotiated in the consent or tripartite deed with the banks to the effect that in the event of termination the Government was required to re-offer the airport for lease for the remaining term of the lease and any net premium

from the re-letting (after enforcement and holding costs) would be payable to the original banking syndicate.

The banks were able to accept this arrangement both because of the return of residual value (which also reduced any incentive for the Government as lessor to act precipitously or unreasonably), which meant that they were not faced with the spectre of a total loss and by virtue of the fact that although the cure opportunities were limited, the triggers for termination were of such a severe nature that the banks were comfortable that they were unlikely to happen.

A similar regime was adopted for the benefit of the banks in the South Australian electricity privatisation transactions.

In the case of the Olympic Stadium, because of the looming Olympics, the Government did not wish to afford unlimited cure opportunities during the construction phase, so eventually it was agreed in the tripartite deed, in exchange for a tighter default regime, that if the Government did take over the project during the construction phase it would pay compensation in an amount equal to a substantial percentage of the outstanding non-recourse debt. The banks were fairly comfortable with this on the basis that any balance could be recovered from the builder (by which the construction phase obligations were assumed).

It is worth noting that most of the transactions in this second category were privatisations, where doubtless the making of a single upfront payment helped focus the attention of all parties on the iniquity of the Government cancelling the concession without returning any value to the private sector.

It should be stressed that the above are end results, reached after very lengthy negotiations. In few of the second category deals was compensation or re-letting provided for in the first drafts issued by the Government with the tender invitation.

With the Victorian and New South Wales governments looking at following the UK model of adopting standardised language as far as possible in documenting private participation in infrastructure provision, it is timely to consider whether an optimum or standard solution can be arrived at. Certainly, an inordinate amount of time has

been wasted over the years in the fight to get these termination provisions into bankable shape.

The general philosophy of the UK approach is that termination should be "very much the last resort" and that termination rights should be for "a catastrophic and long term failure of the project service" or "chronic and persistently unremedied bad performance". Compensation is not ruled out, but should be limited. "You should ask yourself whether the financial arrangements are equitable. But PFI involves paying for services, and if there is no service being provided, there is no presumption of payment. Clearly the arrangements must provide a keen incentive on the private sector not to default."[11] When compensation is payable, the amount is typically based on a calculation of the present value of projected future net revenues.

In cases involving essential or important infrastructure the Government will be concerned at maintaining continuity of service or access for the public. However, this issue is typically dealt with by the inclusion of step-in rights, and should not be seen as a valid argument for forfeiture without compensation.

Forfeiture without compensation is an extreme measure and the insistence by the public sector on such an approach will lead only to a diminution of the appetite of the private sector for such projects. Query whether the approach gives the public sector the best result in any event, given that:

- it generates a concern at the possibility of public sector opportunism, taking back the asset in the case of minor or technical defaults, so leads to private sector insistence on qualifying the default provisions to include materiality tests and extensive or open-ended cure periods, creating considerable contractual uncertainty as to the operation of the provisions; and
- because it is inequitable, it leaves scope for considerable uncertainty as to the operation of the termination provision, with the strong likelihood of the private sector bringing claims based on a variety of grounds, said by some commentators to include unconstitutional expropriation without compensation, the doctrine of penalties, the equitable jurisdiction to relieve

[11] See Graham D. Vinter, *Project Finance* (2nd Edition) p250.

against forfeiture and for general law restitution on grounds of unjust enrichment.[12]

This second point is worth looking at more closely. What are the prospects of success for such claims? The first two can be dismissed pretty quickly. Even if the termination of a lease in accordance with its terms could be characterised as an acquisition of property on unjust terms, the only constitutional protection against expropriation in Australia is in relation to federal laws having that effect (under pl.51(xxxi) of the Commonwealth Constitution). That protection has no application to contracts or leases, especially if made under State law.[13]

The suggested application of the doctrine of penalties ignores the basic distinction between penalties and forfeiture. As the Australian High Court put it:

> "A penalty, as its name suggests, is in the nature of a punishment for non-observance of a contractual stipulation; it consists of the imposition of an additional or different liability upon breach of a contractual stipulation. ... On the other hand, forfeiture involves the loss or determination of an estate or interest in property or a proprietary right, eg a lease, in consequence of a failure to perform a covenant."[14]

It is clear from this that the loss of the concession or lease is in the nature of a forfeiture, not a penalty.

The equitable jurisdiction to relieve against forfeiture[15] seems likely to be the most fertile field for the private sector to till. Essentially that jurisdiction is driven by the concept of unconscionable conduct. There is scope for the grant of relief against termination where "the object of the rescission [or termination] is not to safeguard the vendor [ie government in this case] from adverse consequences which he may suffer as a result of the contract remaining on foot, but merely to take unconscientious advantage of the benefits which will fortuitously accrue to him on

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[12] Vinter, *Project Finance* (2nd Edition) p43.

[13] See *Durham Holdings Pty Ltd* v *The State of New South Wales* [2001] HCA7.

[14] *Legione* v. *Hateley* (1983) 152 CLR 406 at 445, Mason and Deane JJ.

[15] Supplemented by statutory provisions for relief against forfeiture contained in the property legislation of Australian jurisdictions. See, for example, s129 of the Conveyancing Act 1919 (NSW).

forfeiture of the purchaser's interest"[16]. In *Legione* v. *Hateley* (at 449), Mason and Deane JJ set out some subsidiary factors for consideration such as whether the conduct of the party seeking to benefit from the forfeiture contributed to the breach or whether the breach was trivial and inadvertent, and involving an assessment of the magnitude of the respective losses and gains of the parties if the forfeiture is to stand, together with a consideration of whether there are adequate alternative remedies.

These factors suggest that it is imperative for a government seeking to exercise the right of forfeiture that it allows genuine cure rights, does not act opportunistically and only seeks to terminate for material breaches. But beyond that, given that the concession documents will have been negotiated between substantial, independently advised parties, it would be dangerous for the private sector to accept onerous termination provisions in the belief that equity will modify their operation in practice.

Absent a special case of unconscionability, it would be safest to bear in mind that "equity expects.men to carry out their bargains"[17].

The last suggestion is that restitution for unjust enrichment may be available. However, it is difficult to see any scope for this remedy to operate independently of the equitable remedy of relief against forfeiture. Both are driven by the concept of unconscionability, but most of the analogous cases have been considered under the relief against forfeiture heading.[18] The unjust enrichment of the Government on forfeiture would simply be a factor for consideration in determining whether the exercise of the termination right is unconscionable.

It is clear from the above discussion that the private sector cannot take great comfort from the uncertainties mentioned above, and is justified in fighting hard to make the termination regime more reasonable.

If the Government agrees that fairness should prevail and some compensation should be payable, how is that to be determined? Clearly the Government will not agree to fixed payments designed to ensure debt is repaid in all circumstances.

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[16] *Legione* v. *Hateley* at 449 (Mason and Deane JJ).

[17] *Shiloh Spinners Limited* v *Harding* [1973] 1All ER at 101.

[18] See Mason and Carter, *Restitution Law in Australia* (1995), pp409-421.

Valuation mechanisms are sometimes objected to because they involve returning to the Government a risk they reasonably thought they had got rid of.

The re-letting formula used in the airport and South Australian electricity privatisations affords the Government a reasonable alternative which avoids this concern. If the Government re-lets the concession on substantially the same terms (for the unexpired term), this should establish the market value. The Government is compensated for its costs and the risks involved in the whole process clearly leave plenty of incentive for the private sector to avoid default. There is doubtless also some scope for the Government to impose an additional penalty in the form of a re-letting fee and/or commission applied to the proceeds of re-letting. The spectre of the losses and costs involved in such a re-letting will provide a very powerful incentive for the private sector not to default.

There are some important points of detail that also need attention. First, although it is easy to talk of cure periods, many defaults are technically incurable. A classic example, of course, is the insolvency of the borrower. As a drafting matter, other defaults such as the failure to do something by a particular time may be technically incurable. It is important, in the drafting of the cure regimes, to include a mechanism to deal with "incurable" defaults. In the case of insolvency, there should be provision for a deemed cure by the banks appointing receivers and, after a period of time (usually capped at around a year), selling the asset to a solvent entity with the technical capability of complying with the concession deed and other key project documents. Other alternatives for "incurable" events of default will include the payment of compensation and/or the taking of appropriate steps to ensure that the default is not repeated.

To conclude, for this topic, on an optimistic note, the Victorian government's March 2001 exposure draft on Risk Allocation and Contractual Issues contemplates that "when the contract is terminated because of a private party default, the contract may provide for compensation to be paid to the private party if failure to do so would unfairly benefit government. This would be the case where, for example, the private party developed the facility...at its cost and it was obliged to transfer the facility to

government on early termination."[19] The paper goes on to suggest that the Government's position is that fair market value less costs and losses caused to the Government provides an appropriate basis for calculating compensation. This is a most welcome development and it is to be hoped that it sets a precedent for Australia-wide deals, and that the Alice Springs to Darwin Railway will be seen as a relic of the "bad old days" of forfeiture clauses in government infrastructure finance.

Two issues affecting equity bridging facilities

Debt being cheaper than equity, it has become fairly standard practice in greenfields project financings involving substantial sponsors, for the equity contribution of the sponsors to be delayed until completion of the construction phase. Instead, under an equity bridging facility the banks lend the "equity contribution" on the security of a sponsor guarantee or, more commonly, a letter of credit or bank guarantee procured by the sponsors. The bridging loan has to be repaid, and the equity contributed, at the earliest of completion, some pre-agreed outside date and default.

Although this seems quite straightforward, there are a couple of traps.

The first is the preference risk associated with lending on the security of a letter of credit or bank guarantee (for convenience I will just refer to letters of credit, though the issues are the same). If the borrower repays the equity bridging loan while insolvent and its winding up commences within 6 months, the repayment of the bridging loan could be set aside as a preference.[20] Unfortunately, by this time, the letter of credit is likely to have expired. Very awkward. The "good faith" defence (s588FG) might be available, but these facilities are provided at fine margins and are meant to be largely risk free.

One way of dealing with this situation might be to require that the letter of credit is provided for a significantly longer period of time, so that it will still be available at the time of preference clawback. This is expensive and cumbersome, and it is difficult to predict when that claim could be made. Another possible solution would be to provide in the loan agreement that if at the time of repayment the lenders have

[19] See the March 2001 exposure draft of the Partnerships Victoria publication on Risk Allocation and Contractual Issues (pp 167 and 168). It is encouraging that the subtleties of cure arrangements discussed above have also been reflected in the draft.

any reason to suspect insolvency of the borrower, they can reject repayment and instead draw under the letter of credit. Although reasonable, this is obviously not a bullet proof solution, as one can never be certain what banks know (or ought to know or suspect), and again it is not favoured.

The most commonly adopted solution is to rely on a direct pay letter of credit, so called because it is not in any sense a standby letter of credit. It is the primary means of repayment of the loan. It is drawn so that it can (and should be) drawn on maturity of the loan to effect repayment, in lieu of any payment from the borrower. The intention being, of course, that there is no payment from the borrower which could be clawed back (and of course the LC issuing bank would normally be relying on security from the sponsors, not the thinly capitalised borrower, for reimbursement of the drawing).

Under the old law of preferences, the direct pay letter of credit was an effective solution. The 1992 corporate insolvency law reforms adopted a wider concept of transaction, but the transaction still had to result in the creditor receiving *from the insolvent company* more than it would have received in the winding up.[21] In the case of a direct pay LC, the key elements thought to keep the preference spectre at bay were that the debtor was not party to the letter of credit and that the payment under the letter of credit did not involve a receipt from the company. Nevertheless the cautious started to include in direct pay LCs wording to the effect that payment under the letter of credit should be made by the bank from its own funds and not from funds of the company.

The full Federal Court decision in *Macks and Emanuel (No.14) Pty Ltd* v *Blacklaw & Shadforth Pty Ltd* (1997) 15 ACLC 1,099 (*Emanuel*) has generated some concern.[22] The facts were complicated and need not detain us.

In holding that a third party payment should be set aside as a preference the Court expressed the view that the new preference legislation permitted aggregation of a composite transaction, being "a totality of dealings initiated by the debtor so as to

[20] Sections 588FA and 588FE of the Corporations Law.

[21] Section 588FA(i)(b) of the Corporations Law (the second limb).

[22] See the note by the author "Letters of Credit as Security in Financing Transactions – Are they Safe?" (1998) 9 JBFLP p222.

achieve the intended purpose of extinguishing the debt". If, as one would expect, the borrower is the account party for the letter of credit, that broad view could be applied to the typical situation described above, ie of an equity bridge loan secured by a direct pay letter of credit, at least where the payment under the LC is procured or funded in some way by the borrower. Certainly *Emanuel* supports the practice of including in the letter of credit language denying that the issuing bank can use funds of the borrower to make the payment.

The decision in *Emanuel* has been criticised, and in *Thompson Land Limited (receiver and manager appointed) (in liquidation)* v *Lend Lease Shopping Centre Development Pty Ltd* [2000] VSC 108 it was suggested it should be confined to its particular facts. In *Thompson Land* it was unsuccessfully claimed that a payment by a bank of bank cheques it issued pursuant to a bank guarantee involved a disposition of property of the insolvent debtor (whose already overdrawn account was debited at the time of payment). McDonald J stressed the independent nature of the obligation of the bank under its performance guarantee, such that even if the wider view of transaction in *Emanuel* prevails, one can still be confident of avoiding the second limb of the preference test by reason that the payment cannot be characterised as having been recovered from the insolvent debtor.

Another point of distinction emerged in the case of *VR Dye and Co v Peninsula Hotels Pty Ltd* (1999) 17 ACLC 954, a decision of the Court of Appeal of the Supreme Court of Victoria. This involved a company in trouble effectively prepaying a firm of accountants for work to be done in assisting with the conduct of a creditor's voluntary winding up. Such arrangements are worthy of a separate paper in itself. Importantly for us, however, was that the appropriation by the accountants of funds made available by way of prepayment was held not to constitute an unfair preference under section 588FA. Although the transaction seemed to fit within *Emanuel*, as involving "a totality of dealing initiated by the debtor so as to achieve the intended purpose of extinguishing the debt", the court was able to distinguish that case on the basis that in this circumstance "the totality of the transaction did not involve the receipt of a payment in respect of an existing debt but merely the setting up of what was seen to be a sufficient and appropriate mechanism for the payment of a new obligation" (at 960).

The mere fact that at the time of the second stage of the transaction (the appropriation of the moneys) the payee was a creditor did not change that conclusion. The court stressed the importance of looking at the totality of the transaction and its ultimate effect. There is an obvious parallel with the setting up of a direct pay letter of credit before a loan is made (and hence before the banks are creditors). This case also supports the further argument that the payment (assuming it does not diminish the borrower's funds) does not disturb the statutory order of priorities among creditors.

So the concerns raised by *Emanuel* have largely been allayed in subsequent cases. Financiers who wish to wear belt as well as braces could also take security over the assets of the borrower, ranking in all respects behind the providers of non-recourse project debt. This should solve the preference problem, but could result in a substantial increase in the amount of any loan security or mortgage duty payable. There are, of course, techniques to minimise this.

The second issue of concern is the impact of the proposed new thin capitalisation rules, to apply from 1 July 2001.[23] At the risk of some over-simplification, the new thin capitalisation rules will now apply to all debt of "foreign controlled" entities in Australia, but with a higher safe harbour debt to equity ratio of 3:1 (previously 2:1). This change is associated with the introduction of new rules about what is equity and what is debt. Debt under the new law is the provision of a benefit to the taxpayer coupled with a non-contingent obligation to return at least the amount of the benefit, while equity is an interest under which the return depends on economic performance. Make of that what you will.

The bottom line, however, is that if a borrower is "foreign controlled" (and, needless to say, you do not have to be foreign controlled to be "foreign controlled"[24]) it will

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[23] See the New Business Tax System (Thin Capitalisation and Other Measures) Bill 2001.

[24] The tests that will determine whether an Australian company is a ***foreign controlled Australian company*** are:

- no more than 5 foreign entities (each holding a control interest in the company of at least 1%) hold an aggregate total control interest of 50% or more;
- a foreign entity holds a control interest of at least 40%, and no other entity or entities control the company (excluding associates of the foreign entity); or
- no more than 5 foreign entities (and their associates) control the company.

face the prospect of limited tax deductibility for the bridging loan. The only way to beat the 3:1 safe harbour rule is to satisfy the arm's length test, by showing that the company could raise all or a portion of the debt in question from third parties at arm's length. The existence of the sponsor guarantee or sponsor procured letter of credit will mean the loan fails the arm's length test. But the test is whether the loan could be raised at arm's length. There could be quite a lot of business waiting for mezzanine debt arrangers offering commitments to provide mezzanine debt tranches for projects that are using equity bridge finance.

One potential mitigant of the severity of these rules will be the tax grouping provisions, which were intended to commence at the same time. Their delay has led to a recent announcement[25] that interim grouping measures, akin to the current loss transfer grouping rules, will apply, and further that multiple entry point groups will be eligible.

Some mezzanine debt intercreditor issues

Speaking of mezzanine debt, the introduction of a new layer of debt in project and infrastructure finance has generated considerable controversy over the appropriate treatment of mezzanine debt. Senior debt, initially at least, tended to take a black and white view – if it wasn't senior secured debt, and hence wasn't going to be included in the loan life and debt service cover ratios, it had to be treated the same way as equity. Equity, wanting the additional flexibility and funding provided by mezzanine debt, and the mezzanine debt arrangers themselves, accepted that mezzanine debt would be subject to cashflow subordination, and would be treated as equity in that sense, but suggested that it should have limited protective rights to recognise its special status. And of course the coming new rules on "debt" and "equity" mean it will be important for the prospect of the mezzanine debt being repaid not to be too remote and contingent.

What rights have mezzanine debt pursued?

The obvious starting point was security. That was not a big issue for the senior banks so long as the security was clearly second ranking. In fact, the way deals have

[25] Treasurer's Press Release No. 038, 22 May 2001: "Thin Capitalisation and Debt/Equity Borderline – Changes to Exposure Draft Legislation."

evolved, mezzanine debt has not been given a separate security package but rather rights under the security trust deed to inherit the senior bank security package once senior debt is repaid.

Other issues have been more difficult. Mezzanine debt has sought controls over what the borrower can do, and also the right in some circumstances to trigger enforcement. The principal concern of the banks with this is the so called "squeaky wheel" syndrome. Typically the quantum of mezzanine debt has represented a small portion of the overall project funding (rarely more than 10%), so the senior banks have been worried that mezzanine debt could set out to cause sufficient trouble (by refusing to give consents or waivers, or seeking to take enforcement action) such that, if the project were in work-out phase, the senior banks might decide that it would be worth buying out the mezzanine debt in order to get rid of them. Expressions like "the tail wagging the dog" have been given a pretty good work-out.

The result of all this has been the introduction of some quite onerous conditions in intercreditor documents. Essentially the mezzanine debt holders are precluded from:

- bringing winding up or other debt recovery proceedings, or instigating enforcement of security;
- receiving additional security or accelerated repayments or, indeed, any payment of an amount which is not otherwise available for distribution to equity.

The senior banks have also required that any waiver they grant of a covenant or event of default under the senior finance documents should bind the mezzanine debt providers as well. If the banks decide that the borrower should be permitted to do something (eg incur some vital additional capital expenditure), their view is that the mezzanine debt should be bound by that decision and should not be able to frustrate it. By and large mezzanine debt has gone along with this, but has sought a number of carve outs from the compulsory waiver provision, essentially focussing on securing an independent right to prevent:

- material changes of business;
- material disposals of assets;

- changes to the cashflow waterfall and senior lock-up provisions or their security priority; and
- new debt raisings.

Not surprisingly, the last item has been the most controversial, and this has led to some interesting compromises. Typically new debt will be permitted if:

- it refinances existing debt (subject to certain safeguards eg it must not have a more accelerated repayment profile or more onerous lock-up provisions);
- it falls within some small basket of permitted additional debt;
- it will satisfy some target projected debt service cover ratio tests (ie where the project is doing well);
- so long as the funding is for a project purpose (as opposed to a distribution to equity), where the projected average debt service cover ratios over some reasonable future period (say the next 3-5 years) will not be worse than they would have been if the debt was not raised (ie where the project is struggling); or
- if the banks are enforcing.

This is all designed to strike a reasonable balance, it being acknowledged that mezzanine debt has a legitimate interest in restricting the amount of senior debt incurred ahead of it, but on the other hand if the borrower is in difficulty and needs to raise more debt for a legitimate purpose (usually capital expenditure), it should be able to do so if this is not projected to make things worse for mezzanine debt.

Another thorny issue is that senior debt like to include in the intercreditor deed a statement that, in exercising their enforcement powers, they owe no obligations whatever, fiduciary or otherwise, to mezzanine debt. The obvious concern is the situation where mezzanine debt are suggesting that, on enforcement, a delay in sale might produce a better price, or the acceptance of a conditional offer which senior debt don't like will have the same result. A compromise which was adopted in the Alice Springs to Darwin Railway project financing was to provide that on enforcement of their securities the senior banks should act in good faith towards the mezzanine debt holders, but only where that is not inconsistent with the best

interests of the senior banks and will not cause the senior banks any greater loss, cost or expense.

Some banks are undoubtedly uncomfortable with such a provision. However, it is suggested that the provision is simply reflective of the reality that the senior banks, or the receiver appointed by them, will be subject to the non-excludable statutory obligation in section 420A of the Corporations Law to "take all reasonable care" to sell the property for the market value or, if none, the best price reasonably obtainable.

Further, although at general law a receiver's paramount duty is to its appointing banks, it also owes duties to subsequent holders of security and to the mortgagor to act in good faith and use its powers for the sole purpose of securing repayment of its appointing mortgagee – see *Downsview Nominees Limited* v *First City Corporation Limited* [1993] AC 295 (Privy Council).

Again in the recent New Zealand case of *Moritzson Property Ltd* v *McLachlan* (HC Dunedin, CP 135/91, 4 December 2000, Elias CJ) it was accepted that receivers appointed by the senior creditor owed an obligation to the subordinated creditors to realise the security in good faith. That duty does not extend to a duty to obtain the most advantageous outcome for the debtor or third party creditors generally.

So the undertaking does no more than reflect the legal realities. It is worth adding, however, that to accommodate bank nervousness, an additional provision precluding resort to equitable remedies to enforce the above duty of good faith was included in the Intercreditor Agreement for the Alice Springs to Darwin Railway, purportedly leaving the mezzanine creditors only with a right of damages. This is a reasonable compromise in the sense that the potential damages claim could be seen as a genuine sanction, while dealing with the banks' concern not to be delayed by intermeddling mezzanine creditors trying to secure a payout causing delay to the enforcement process. The overriding difficulty for the senior banks is that you cannot contract out of section 420A of the Corporations Law. About that, nothing further can be done.

The final "hot" issue with mezzanine debt is the question of how long their rights to trigger enforcement can be postponed. In the corporate debt market, mezzanine or subordinated debt tends to be subject only to relatively short blockage periods (as

little as 180 days), after which the holders can take steps to trigger acceleration and enforcement. This is the American "fish or cut bait" concept. If there is a default the senior banks have to do something about it. They cannot sit on their hands while the mezzanine debt interest capitalises. There is a certain logic to this position in relation to a company operating in a normal cyclical business environment. There may be some advantage in acting quickly, and there are likely to be more options for restructuring in a work-out.

In a project financing, and more particularly infrastructure projects, the cashflows are typically more stable and there may be less that the owners can do to improve financial performance. In any event, whatever the justification, the senior banks have not accepted the concept of short term blockage periods in infrastructure finance. The best that has been negotiated to date is a blockage period which only ends 3-5 years after scheduled senior bank maturity, and then only if the banks aren't enforcing by that time. In other words, if the bank maturity date has passed and the banks are still not enforcing after 3-5 years, then the mezzanine debt will finally have their day! They cannot trigger enforcement before then. Tough, but that is where the market is at the moment.

Taking security over contracts

Hardly a new topic, but taking effective security over contracts is of such fundamental importance to project finance that a short treatment of one issue is required. All the more because it is the author's experience that there is scope for a serious misunderstanding of this issue, especially where the contracts aren't purpose built for project finance (eg in privatisations).

Most commercial contracts contain some kind of prohibition on assignment, and many others are silent on the issue. Very few specifically deal with the granting of charges over rights under the contract by one of the parties. The author has seen a number of due diligence reports which contain statements which adopt the following line of reasoning in relation to key contracts reviewed:

- there is a restriction on assignments;
- but no prohibition on charges (or, indeed, on equitable mortgages);

- therefore the proposed charge (or equitable mortgage) in favour of the banks is permitted.

That is not an untenable position, at least in relation to charges. In an article entitled "Debts and Non-Assignment Clauses" Professor Gerard McCormack stated "since assignments and charges are conceptually different, in principle a non-assignment clause in a contract should not catch the creation of a charge".[26] There is obviously a difference in wording, but what, really, is the substantial difference between an equitable assignment by way of security, and a charge? Philip Wood, in *English and International Set-Off*, at pages 913-915, suggests that, at least for set-off mutuality purposes, there is no difference between an equitable assignment by way of security and a charge. Both effectively confer the same proprietary interest on the assignee/chargee. Wood points out that the courts tend to use the term equitable assignment and charge interchangeably. He cites cases like *Durham Brothers* v *Robertson* [1898] 1 QB 765 at 769 where Chitty LC stated "a mere charge on a fund or debt operates as a partial equitable assignment"[27].

And the whole "conceptual impossibility" argument concerning charges over bank accounts with the chargee proceeds on the basis that a charge is a kind of assignment (see the *Cinema Plus* case (2000) 49 NSWLR 513).

The issue has been considered in a couple of recent Australian cases which should, perhaps, be better known. Both applied the House of Lords decision in *Linden Gardens Trust Limited* v *Lenesta Sludge Disposals Limited* [1994] 1 AC 85. In *McIntosh* v *Turner Corporation* (1995) 13 ACLC 1314 at 1316, Sackville J held that a bare prohibition on assignment of "this agreement" meant that a charge was ineffective to create any effective security over the rights under the agreement (but did not stop the charge catching moneys received as a result of performance of the contract). In *Westgold Resources NL* v *St.George Bank Limited* (1999) 17 ACLC 327, a purported assignment by way of security of rights under a contract which contained a prohibition on assignment was again held to be ineffective (though the purported assignment was held not to be a repudiation of the contract).

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[26] [2000] JBL 422 at 440.

[27] And also *Rodick* v *Gandell* (1852) 1 DM&G 763 and *Palmer* v *Carey* [1926] AC 703.

So the better view is that a charge is a kind of assignment, and the prudent course is to assume that a prohibition on assignments extends to a prohibition on charges and equitable mortgages, and that a purported charge or equitable mortgage in breach of that prohibition will be ineffective. Bear in mind, too, that most charges have a further assurances clause which could operate as an equitable assignment. The other point, perhaps too obvious to mention, is that the absence of a prohibition on assignments does not, of course, mean that assignments (or charges) are permitted. That would be a matter of construing the whole contract in considering the nature of the services provided under it – it may well be too personal to be capable of assignment.[28]

Enforcing security over contracts – receiver and bank liability

From the banker's viewpoint, one of the best features of English law is the ability to appoint a receiver and manager under a security to take control of the assets and business of its borrower. This technique is largely unavailable in continental Europe and in the United States (where chapter 11 puts secured creditors out in the cold). Subject to certain qualifications, the receiver acts as the agent of the mortgagor, not its appointing banks, and incurs liabilities which are only recoverable against the mortgagor.

Following on from the previous topic, if the banks appoint a receiver and manager (for convenience, referred to simply as a receiver) to a mortgagor in a project financing, to what extent can the receiver (and hence the banks under the indemnity they always have to give the receiver) be liable to other parties to the project contracts? Or, putting a more positive spin on it, can the receiver "disclaim" any onerous contracts with impunity?

Take, for example, the situation where a power station is rendered uneconomic by a long term fuel supply contract which is substantially above market. Can the receivers ignore that contract and simply contract for fuel supplies elsewhere (at cheaper

[28] See Meagher, Gummow and Lehane, *Equity: Doctrines and Remedies* (3rd Edition) at pp200-203.

rates)? It all, of course, depends on the terms of the contract and of any applicable consent deed[29]. But first let us look at some general principles.

The deed of charge invariably provides that the receiver is appointed by the mortgagees but acts as agent for the mortgagor. As an agent, the liabilities that it incurs will, on normal principles, fall upon the principal (the mortgagor). So generally the receiver can elect either to continue to perform the contract (without incurring personal liability) or to ignore it, again without incurring liability. Absent special factors, the receiver is in a better position than the mortgagor with respect to pre-existing contracts. The receiver is free to disregard such contracts for the purpose of better realising the mortgagor's assets or improving its trading prospects.[30]

However, there are a number of important qualifications or exceptions.

First, the receiver will be personally liable if it adopts the contract. On this score, the normally reliable Graham Vinter might cause some alarm with the following statement in *Project Finance*:

> "It used to be thought that merely continuing to comply with the company's continuing obligations under a contract did not constitute adoption, but this proposition was soundly quashed by *Powdrill* v *Watson* [[1995] 2 All ER 65 (the *Paramount Airways* case)] where the House of Lords held that, if an administrator or receiver simply continued with an employee's contract of employment for more than 14 days, they adopted that contract." (page 164)

The reader can be reassured that not only has the case has not been followed in Australia, but even in the UK it has been confined to its particular context (employment contracts). The decision was essentially driven by consideration of particular UK statutory provisions. This is clear not only from a consideration of the case itself, but also from subsequent cases such as *Roger Lindop* v *Stuart Noble & Sons Ltd* [1998] Scot CS 15 and *Brown* v *City of London Corporation* [1996] 1 WLR 1070. In the latter case Arden J analysed the impact of the *Paramount Airways* case as follows:

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[29] The agreement between the borrower, the security trustee and the contract counterparty under which the latter consents to the charge, agrees to give the security trustee certain cure rights, and makes various other acknowledgements. Also known as a tripartite or direct agreement.

[30] For an extreme example, see *Airlines Air Spares Limited* v *Handley Page Limited* [1970] 1 Ch 193.

> "The liability in damages for non-performance of a pre-receivership contract ranks as an unsecured liability and so it does not diminish the assets available to meet the claims of the mortgagee who has appointed the receiver. Parliament has intervened so that a receiver is now personally liable on post-receivership contracts entered into by him (unless the contract otherwise provides), and also on pre-receivership employment contracts made before his appointment which he adopts in the course of carrying out his functions.
>
> It is noteworthy that Parliament has not abolished the agency status of the receiver but has merely imposed personal liability on the receiver for acts done by him as a receiver in specified cases: see sections 37 and 44 of the Insolvency Act of 1986, as amended. (Indeed it is arguable that the Act of 1986 has enhanced the agency of receivers.) This would suggest that the policy of the legislature is to retain the immunity which the receiver enjoys as an agent except in those specified cases. One reason for this may be that the institution of receivership as traditionally structured provides benefits to lenders... and thus may make commercial borrowing easier."[31]

The general position in Australia was stated by Needham J in *Re British Investments and Development Co Pty Ltd*[32]. "This is a case where the Receiver was carrying out an existing contract made by the company before the Receiver went into possession and, in that event, the general law is that unless he personally makes himself liable then, by merely carrying out the contract, he does not accept a personal responsibility".[33]

In practice the advantages of these principles may be illusory where the contract entitles the counterparty to terminate if the company has a receiver appointed to it. In such a case a counterparty can be expected to refuse to accept further orders unless the receiver adopts the contract or provides other security or concessions. So

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[31] See also the analysis of the *Paramount Airways* case by O'Donovan, *Company Receivers and Administrators*, at pages 4122-4123. The law in Australia remains, as O'Donovan puts it at page 4123, that "receivers and managers should not be taken to have adopted these contracts [of employment] simply by allowing the company, as employer, to continue the contract."

[32] [1979] ACLC 40-522 at 32,102.

[33] See also *Parsons* v *The Sovereign Bank of Canada* [1913] AC 160, where a receiver who continued to place orders under a contract for the supply of paper which had been entered into before the receivership did not incur personal liability.

one of the main purposes of consent deeds in project finance is to provide that the appointment of a receiver will not be a default under the contract.

Secondly, there are statutory exceptions in sections 419 and 419A of the Corporations Law for debts incurred in the course of the receivership for services rendered, goods purchased and property hired, leased, used or occupied. It is generally accepted that the statutory personal liability is limited to the specific cases mentioned, and would not extend to the mere performance by receivers of a contract of the company which was in existence at the time of appointment, on the reasoning that the debt must be incurred by the receivers (ie for which the receivers personally make themselves responsible).[34] The application of this reasoning to the continued occupation of leased premises led to the introduction of section 419A.

The third exception is where the mortgagor is being wound up. It is well established that a receiver cannot, on behalf of a mortgagor which is being wound up, incur debts provable in the winding up as agent of the borrower. Most charges provide that in that situation the receiver can continue to act, but as agent for the mortgagee. This strategy has been well recognised in the cases[35].

This is a material exception to the general rule, as liquidation can hardly ever be ruled out. It is worth noting in the project finance context:

- it is unlikely that a substantial creditor would remain unpaid (most operating costs are given cashflow priority in a project financing); and
- with the banks holding security over all assets, little could be gained from the expense of pursuing the winding up (but that factor is not sufficient to rule out the making of a winding up order – see the Channel 10 case[36]).

This is, nevertheless, an uncomfortable position, and will force a quick decision on whether to stay with a contract or abandon it. The good news is that, since the 1992 corporate insolvency law reforms, the winding up only commences (for most purposes) at the earlier of the making of the order or, if the company was first in

[34] See *Re British Investments* (cited above) and *Sipad Holding ddpo* v *Popovic* (1995) 19 ACSR 108 at 111 (Lehane J).

[35] See for example *Mercantile Credits Limited* v *Atkins (No. 1)* (1985) 9 ACLR 757 (at 765).

[36] *New South Wales Rugby League Ltd* v *United Telecasters Sydney Ltd* (1991) 9 ACLC 680.

administration, the commencement of the administration (ss513A and 513C, Corporations Law). So the receiver and the banks will, at least, know where they stand.

There is also an escape hatch in section 420C of the Corporations Law which empowers a receiver of a corporation that is being wound up to carry on the business as agent for the corporation, with the approval of the corporation's liquidator or of the Court. Although debts so incurred are personal liabilities within section 419, on the logic concerning the application of section 419 to existing contracts, it would seem that if the receiver does get approval under section 420C, the continuing liabilities incurred by virtue of the performance of existing contracts on behalf of the corporation will not be personal liabilities of the receiver.

The fourth, and rather difficult but important exception, is that a receiver takes subject to "prior equities". The principal prior equity for our purposes is the right of a counterparty to a contract to enjoin the receiver, in its capacity as agent for the company, from breaching a negative stipulation in a pre-receivership contract. So although a receiver can generally disregard a pre-receivership contract and leave the counterparty to pursue the (insolvent) mortgagor for damages, if the contract contains a negative stipulation, that stipulation may be enforceable by equitable remedy.

As a creature of equity, relief is always subject to discretions, and reference should be made to some of the exceptional examples provided in O'Donovan's *Company Receivers and Administrators* at [8.490]. The cases, in fact, are difficult to reconcile, and on the question of whether a receiver must comply with pre-receivership contracts affording rights of first refusal or pre-emption, the judgments go either way.

The applicable considerations are complex and interactive. On the one hand, a factor in favour of granting equitable relief would be that damages awarded against an insolvent company will not usually be an adequate remedy, but on the other hand relief has been refused on the grounds that the effect of the order would be to give an unsecured creditor an unfair preference over other unsecured creditors.[37]

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[37] See O'Donovan, *Company Receivers and Administrators*, at p2939.

It is tempting to think that where the mortgagor is in liquidation, and the receiver's agency comes to an end (at least in some respects), the concern with negative stipulations might fall away. However, the prior equity concept seems also to bind the consciences of the mortgagees[38].

In *Schering Pty Ltd* v *Forrest Pharmaceutical Co Pty Ltd* [1982] 1 NSWLR 286, the company in receivership had entered into a franchise agreement which contained a negative stipulation restricting the way the company could market its goods. An injunction was granted against the receiver to restrain breach, even though the judge hearing the case acknowledged that the negative stipulation had driven the company to the wall and that enforcing the stipulation would increase the losses incurred by other creditors. Helsham CJ declared "In my view, the law does not permit a receiver of a company to avoid onerous contracts. He is in law, when acting within the scope of his authority, the agent for the company and he can do no more in relation to contractual obligations than the company can itself."[39]

The remedy of an injunction to restrain breaches of negative stipulations has long been extended to cover implied negative stipulations. Particular examples include exclusivity covenants, positively expressed, which implicitly import a negative.[40] The difficulty, of course, is that almost every positive obligation carries with it an implied negative. In *Lake Eerie Pty Ltd* v *Knight* (unreported, Full Court of the Supreme Court of Queensland, 11 February 1992)[41], it was accepted that an implied negative stipulation could give rise to a prior equity which would be binding on a receiver, but

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[38] See *Re Diesels and Components Pty Ltd (Receivers and Managers Appointed)* (1985) 9 ACLR 825. McPherson J provides a useful summary of the position in *Re Diesels* at pp827-8 "If [a receiver] repudiates the contract he renders the company liable in damages for the breach of contract involved in that repudiation. Because the chargee who appoints him has the benefit of a security over the assets of the company, the consequences of rendering the company liable in damages are in practice felt only by the company and through it its unsecured creditors, and not by the holder of the charge. The company's indebtedness to the chargee will be met out of the assets in priority to the claims of unsecured creditors including the claim for damages of the other party to the broken contract. The receiver therefore can, with virtual impunity, repudiate pre-receivership contracts. I say "with virtual impunity" because, as is shown by *Schering Pty Ltd* v *Forrest Pharmaceutical Co Pty Ltd, supra*, there are cases in which damages may be an inadequate remedy for breach of contract, and where the other party may therefore be entitled to either specific performance or an injunction that has the effect of obliging the company, and through it the receivers and the chargee, to adhere to and perform the pre-receivership contract."

[39] *Schering Pty Ltd* v *Forrest Pharmaceutical Co Pty Ltd* [1982] 1 NSWLR 286 at 291.

[40] See Meagher, Gummow and Lehane, "*Equity: Doctrines and Remedies*" (3rd Edition) at p570.

[41] Discussed in O'Donovan, *Company Receivers and Administrators*, at pp2942-2943.

on the facts of the case such an implied term was not to be found. The trial judge had relied on an implied negative stipulation "not to repudiate [the contract] or terminate it except in compliance with its terms". If this had been sustained, then every contract would contain such an implied negative stipulation the breach of which could be restrained by injunction.

Going back to our original example, one can say with reasonable certainty that if the onerous fuel supply contract either:

- precludes the mortgagor from acquiring fuel elsewhere; or
- requires the mortgagor to acquire its fuel supplies exclusively from the mortgagor,

it is likely that an attempt by the receiver of the mortgagor to acquire fuel elsewhere, even at considerably lower prices, could be restrained at the instance of the fuel supplier by means of an injunction to enforce the express or implied negative stipulation.

The issue might arise in a more dramatic context. What if the receiver finds a purchaser of the plant, prepared to pay considerably more if it can purchase the plant free of the onerous supply contract? In the author's experience, it is quite rare for fuel supply contracts to contain an express restriction on disposal of the plant (though obviously from the fuel supplier's perspective that would be desirable). If there were such a negative stipulation, then it goes without saying that it could ground an injunction to prevent the sale. What scope is there for an implied negative stipulation?

As noted by Meagher Gummow and Lehane, the jurisdiction to restrain breaches of implied negative stipulations casts the net very wide, especially if one takes account of comments such as the following statement by Griffith CJ in *O'Keefe* v *Williams* (1910) 11 CLR 171 at 191 "Every contract between subject and subject involves an obligation, implied if not expressed, that neither party shall do anything to destroy the efficiency of the bargain he has made." Clearly sale of the plant would destroy the bargain. So again one cannot rule out the possibility of an injunction.

In project finance the issue of bank/receiver liability will commonly be affected by contractual provisions in a consent deed between the mortgagor, the banks' security

trustee and the counterparty. The bank's first draft will usually include a provision to the effect that the exercise by the mortgagee or a receiver appointed by it of powers under the security will not of itself give rise to personal liability under the contract for the receiver or the mortgagee. That provision would not override section 419, but as we have seen, that section will not normally apply to the ordinary case of continued performance by the receiver of a contract. However, such a provision would be unlikely to be interpreted as precluding the right of the counterparty to seek an injunction to enforce a breach of a negative stipulation. To overcome that provision would require an express provision which is most unlikely to be agreed. The best one can do is try to keep negative stipulations out of the contract, for example by possibly raising the spectre of the Trade Practices Act prohibition on exclusive dealing, which favours contracts for quantities rather than exclusivity contracts.

It is not uncommon for counterparties to insist that if a bank or receiver steps in, it should be bound by the contract. The resolution of this issue will depend on the respective parties' bargaining power, especially whether the supplier is an insider or an outsider. In the case of a pre-existing arm's length contract, particularly with a government body, little progress can usually be made. The key in that circumstance is to be satisfied (or ensure) that the liabilities incurred during the receivership are limited to payments for fuel supplied and do not extend to uncapped liabilities of any kind (particularly in damages for breach); and further that liabilities will cease to accrue once the receiver steps out. That is a fairly common compromise and should not be unacceptable given, as noted above, that in any event the finance documents will normally provide that the payment of key suppliers has cashflow priority over the banks.

A possible fifth (and final) exception lies in tort. It has sometimes been suggested that the receiver which disregards (and hence allows the mortgagor to breach) a pre-receivership contract could be sued for the tort of inducing a breach of contract. The issue was raised in the *Airlines Spares* case but dismissed by the Judge. The general principle seems to be that a person acting as an agent cannot be liable for the tort of interference with contractual relations, so it is only where a receiver is not acting bona fide or acts outside the scope of its authority that it might be held liable for inducing a breach of contract.

Tax consolidation

One of the major planks of the current business tax reforms is the introduction of new provisions for the consolidated income tax treatment of groups of Australian entities.[42] Essentially a consolidated group of wholly owned Australian entities with a single common head entity would be treated as a single entity for income tax purposes. The existing grouping provisions would be repealed, and a group would have an election either to consolidate or not, but if the election to consolidate is made, all Australian resident group entities would be obliged to consolidate.

The new rules were to commence on 1 July 2001, but the starting date has been deferred to 1 July 2002.[43]

Tax consolidation raises many complex issues, but clearly has particular relevance for project finance. Greenfields projects always throw up early tax losses (interest during construction and capital allowances) which would typically provide tax shelter for many years of operations. Carrying tax losses forward is inefficient, so sponsors participating through wholly-owned entities would normally wish to utilise the tax losses of the special purpose vehicle immediately. Banks have typically been forced to accept this, but subject to protective mechanisms which include the requirement for payment for the value of the tax losses and/or indemnities against the resulting accelerated tax liability. To date, it has, of course, been an option for the banks to impose a contractual restriction on the right of the project subsidiary to transfer tax losses. That will obviously change under the new regime, given that if the head entity makes the election, the Australian subsidiaries are automatically consolidated for tax purposes.

Although the introduction of the change has been delayed, given the long term nature of project financing, it is important for the issue to be addressed now.

One particularly troublesome aspect of the reforms is the possibility that they will involve joint and several liability for tax. The current position is that the primary liability for group tax will fall on the head entity. However, the explanatory material

[42] See the exposure draft of the New Business Tax System (Consolidation) Bill 2000, published on 8 December 2000.

[43] Treasurer's Press Release, 22 March 2001, "Business Tax Reform Implementation Timetable".

accompanying the exposure draft suggested that "special rules for the recovery of income tax debts from subsidiary members where the head entity defaults on its primary obligation will be addressed in subsequent additions to the consolidation legislative regime."[44] Those provisions have not yet seen the light of day, but may be productive of concern, at least if they involve any element of joint and several liability.

A basic precept of project finance (with its hallmark use of special purpose entities) is that the entity must be isolated from the rest of its group (and so cannot, of course, participate in such things as class order guarantees). Indeed, it is a mandatory requirement of the rating agencies that the project vehicle is "bankruptcy remote". The possibility that a subsidiary could be liable for tax payable by its parent which is unrelated to the project would not be acceptable to the rating agencies or, indeed, the banks. Given that the change from joint and several liability originally recommended in *A Tax System Redesigned* was driven by, among other things, credit rating concerns, there are grounds for hope that any supplementary legislation will respect that principle.

At this stage, apart from flagging the issue and being prepared to engage in active lobbying, there is not a great deal that can be done.

What we have seen in project finance documentation is a requirement that, if a project vehicle is a member of a group for tax consolidation purposes, then:

- it must be compensated for the use of its tax losses; and
- all the other members of its group (or, with the consent of the majority banks, at least one other member of the group which is of a sufficiently strong credit standing) must indemnify the project vehicle for any tax liability it incurs which it would not have incurred if it were a stand alone entity for tax purposes.

The second limb gives rise to a concept of "notional tax", which is then used for ratio calculations and, indeed, is reflected in the waterfall provisions. If tax is permitted to be paid out of cashflow ahead of debt service, then the change means

[44] Section 1.22 of the Explanatory Material.

that the borrower will need to introduce the concept of notional tax because the borrower will not, itself, be directly liable for tax, but will merely be putting its holding company in funds to pay the relevant share of the tax.

A final concern is that if the project entity does not group for tax purposes and the banks have security over all the shares in the project entity, they may have an opportunity to realise value for accumulated tax losses on enforcement if they sell the company rather than the project. The compulsory tax consolidation will mean that the banks cannot realise value for the accumulated tax losses.

Conclusion

One major US law firm is said to have withdrawn from the project finance market on grounds that it has become too commoditised and hence unprofitable. Although for a time, during the era of peaking power plants supported by power purchase agreements, such as Oakey Power and Mt Stuart in Queensland, things became rather standardised, the opening of the electricity market to competition and the introduction of pool pricing has meant new challenges, witness the Millmerran and Callide C power project financings. Certainly, the recent transactions on which the author has worked, such as the Alice Springs to Darwin Railway and the Stanwell Magnesium Plant, have raised many of the issues discussed above, and provided other challenges.

As should be evident from this brief survey, project finance remains an interesting and changing game, with little sign of the commoditisation which heralds the onset of boredom.

Phillip Cornwell
31 May 2001