PROJECT FINANCE REVISITED

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SUMMARY

Project financing is extensively used in Australia. Many of the major mineral and petroleum projects of the last 30 years could not have been undertaken without project financing. More recently, project financing has been used to fund a wide range of infrastructure projects such as tollroads, ports, railways, power stations, water and sewage plants and social infrastructure such as schools, prisons and hospitals. Project financing can be used successfully to finance almost any form of endeavour which has a reliable cash flow.

The paper examines:

- *Choice of project vehicle* - in Australia, there are several types of entity available when considering how to structure project ownership - company, unincorporated joint venture, partnership or trust. Each raises issues for consideration from a project finance perspective.

- *Current key issues for project financiers* - financial ratios, cash control mechanisms, market flex, material adverse change events of default, tax risk (particularly tax consolidation), adoption of new accounting standards, insurance and the impact of terrorism on the insurance market are all key issues which project financiers will need to consider.

- *Project finance documentation* - the negotiation of documents between project financiers and project counterparties is often difficult and time consuming. The starting point is to understand some of the key issues which arise in respect of the documentation which is used in the project finance context.

- *Public/Private Partnerships* - contracts with Government raise a number of issues which project financiers need to consider. With an increasing number of Public/Private Partnership projects now coming to the market, project financiers will face some new issues.

What is project financing?

Before looking at the aspects of project financing referred to above, it is helpful if we understand the essence of project financing.

Two conventional definitions of project financing, by respected commentators, provide a good starting point.

Project financing is:

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

> *"a financing of a particular economic unit in which a financier is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral*

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

for a loan."[2]

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

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

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

CHOICE OF PROJECT VEHICLE

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

The use of a special purpose vehicle will not necessarily insulate the project sponsor from responsibility for problems with the project. For example, in the *Pioneer* case,[3] Pioneer, as the controlling shareholder of Giant Resources NL, and Pioneer's nominee directors were successfully attacked under the insolvent trading provisions of the *Companies Code*. Pioneer, as controlling shareholder, was found to be a shadow director for a period because it had effective control of the company through its 42% shareholding and because it exercised control in practice. In that case, three major decisions were made by Pioneer without receiving independent consideration by the board of Giant Resources. In one case the board of Giant Resources simply accepted Pioneer's decision as a *fait accompli*.

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

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

In the case of a foreign sponsor, it is not uncommon to find that the project sponsor uses two or more special purpose vehicles with, for example, the project vehicle being incorporated in

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

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

the country of the project and the holding company of the project vehicle being incorporated in the project sponsor's country or some third jurisdiction. In theory, this is to enable easy disposition of the project (through the sale of the shares in the intermediate holding company) if, for political or taxation reasons, it is difficult to dispose of assets or shares in the country in which the project is situated. There may also be taxation or other benefits in such a structure.

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

Incorporated joint venture

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

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

The principal advantage of the incorporated joint venture is that, in common with the use of a special purpose company by an individual project sponsor, it largely insulates the sponsors from personal liability for the carrying on of the project. As a shareholder, a project sponsor is largely protected from direct attack by the creditors of a project company. However, the project sponsor will be vulnerable to attack if it is the holding company of the project company and the project sponsor or its directors are aware that there are reasonable grounds to suspect the insolvency of the project company or the project sponsor's control over the project company means that it is reasonable to expect the project sponsor or its directors would be aware of the project company's insolvency.[4]

Partnership

A partnership is defined by the various Partnership Acts in force in the states and territories of Australia as "the relationship which subsists between persons carrying on business in common with a view of profit". Although the concept of a "business" is usually associated with a need for "system and repetition", there is ample authority that a partnership can be formed for the purpose of a single project.[5]

Partnerships have been used increasingly in Australia as vehicles for carrying on energy and infrastructure projects. Partnerships are "pass through" vehicles for income tax purposes - they are not separately taxed but profits and losses flow through to the partners and are taxed in their hands. The fiduciary obligations partners owe to each other, the ability for individual partners to pledge the partnership's credit, and the fact that partners have no title to specific partnership assets, give rise to certain risks for project sponsors considering the use of such a project vehicle. However, many of these risks can be minimised through the use of special purpose vehicles to act as partners and through tight control of the activities of these vehicles by project financiers.

Under the various Partnership Acts of each state, a partner has no direct interest in the assets of the partnership and has only a right to its share of profits and, on dissolution of the partnership, a right to the relevant proportion of the surplus remaining after realisation of all

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[4] Corporations Act, s. 588V.

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

assets and payment of partnership liabilities. This makes financing by individual partners of their contribution to the partnership difficult because they cannot give the financier a direct security interest in the partnership property. For this reason, it is usual for the members of a partnership to borrow and give security collectively as a partnership rather than individually. Arguably, a partnership cannot give effective security unless all of the partners are joined in, and are parties to, the relevant mortgage or charge.

Unit trust

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

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

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

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

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

(b) secondly, financiers will invariably require special trustee representations, warranties and undertakings which relate to the trust itself. Care needs to be taken to ensure that the trustee only gives such representations, warranties and undertaking in its trustee capacity only and not in its personal capacity - trustees should only give representations, warranties and undertakings in their personal capacity where they relate to the trustee itself;

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

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

undertakings in the security. This is considered satisfactory as the custodian, generally speaking, must act as directed by the trustee or responsible entity.

Unincorporated joint venture

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

The typical joint venture is governed by a joint venture agreement which attempts, so far as possible, to make the relationship between the parties purely contractual and free of any fiduciary obligations between venturers. The agreement will usually define the project which will be the subject of the joint venture, confirm that the parties hold joint venture assets as tenants in common and will deal with them only as provided in the agreement, provide for payment of project expenses proportionately by the joint venturers, appoint a manager/operator to run the project for the venturers, provide a decision making process, and set out the rights of joint venturers on default. Although other approaches can be taken, joint venture agreements usually deal with the prospect of default by a joint venturer either through dilution of the defaulting joint venturer's interest in the project to the other joint venturers or by the grant of a cross charge by each joint venturer over its interest in the joint venture and any product it derives from the joint venture, or both.[6]

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

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

(a) they are not being carried on in common; and

(b) they are being carried on with a view to personal profit rather than collective profit.

Surprisingly, despite the continual use of the unincorporated joint venture over the last 40 years, the concept has not been authoritatively endorsed by Australia's highest court[7] and has been attacked by some commentators as constituting a partnership.[8] Nevertheless, most commentators have supported the joint venture as a concept separate from partnership. It is probably now too late for the High Court to change the law after having had the direct opportunity to do this on at least three occasions.

If financiers are lending to the venturers in a joint venture collectively, it will be of little significance whether or not the relationship between the venturers is that of partners or of joint venturers. On the other hand, if financiers are lending to an individual venturer, then it is very important because a partner is unable to charge its share of the partnership assets; it can

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

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

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

only charge its share of the surplus remaining after partnership liabilities have been satisfied. Even if the relevant property is registered in the name of the partners in their relevant partnership shares, it is probable that the partners hold that property on trust for the partnership, in which case if the security is given in breach of trust it may be set aside except to the extent protected by statutory indefeasibility provisions.[9]

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

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

The joint venture agreement will generally exclude fiduciary obligations as between venturers (to the extent that this is possible)[10] and prohibit the venturers from disposing of or partitioning their interest in the joint venture property except in accordance with the terms of the joint venture agreement.

Clearly, the possibility of forfeiture of a defaulting venturer's interest would be a major concern to a financier, even though the enforcement of forfeiture provisions would in some cases be subject to relief against forfeiture. If a venturer's interest in the project can be diluted (ie, reduced) as a consequence of a default under the joint venture agreement or a decision not to meet a cash call, then the dilution formula should be carefully examined to ensure that the rate at which the venturer's interest is diluted is not so harsh as to be penal.[11]

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[9] At least one learned commentator has suggested that this may not be as great an issue as suggested here. Justice Lehane has suggested that a partner, or a joint venturer in circumstances where the joint venture has been categorised as a partnership, can charge its beneficial interest in the partnership assets provided that the terms of the partnership agreement allow it to do so and the other partners consent. It would appear that the reasoning behind this conclusion is that, where the other partners have consented to the charge, those partners, as equitable interest holders in the partnership, have agreed to cede their equitable priority to that of the partner seeking to independently mortgage its interest and its financier. Alternatively, he argues the nature of the beneficial interest of the partnership and the rights of partners under the various partnership acts to exclude property from partnership assets allows partners, with the consent of the other partners, to carve out their interest from the partnership property for the purpose of charging that interest. It is, however, open to argument whether the right of a partner to charge its individual interest and the ability of the other partners to consent to the charge is consistent with the obligation under each Partnership Act for partners to hold partnership property and apply it exclusively for the purposes of the partnership. For more on this issue see J. Lehane, "Current Legal Issues Relating to Lending to Trusts and Partnerships" in *Banking Law and Practice, 14 Annual Conference Papers*, (Sydney, 1997), p.301.

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

[11] Equitable relief against forfeiture is a highly technical area and the scope for its application may be limited in project financings which have elaborate and highly regulated default and cure regimes (see P. Cornwell, "Project Finance", in *18th Banking Law Conference* p11-14). For a recent

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

The deed of covenant must regulate priorities between the joint venture cross charges (if any) and the financier's security. It is well accepted by financiers in Australia that a joint venture cross charge should rank in priority over a financier's security but only to the extent that the joint venture cross charge secures calls under the relevant joint venture agreement and, if necessary, excludes calls in relation to extensions of the project or new projects entered into under the joint venture agreement which have not been approved by the financier. One commentator has, however, queried whether an uninsured claim by a third party against a project manager for environmental damage should rank ahead of project financiers?[12]

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

How Are The Sponsor's Funds To Be Contributed To The Project Vehicle?

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

Interest payable on subordinated loans borrowed by the project vehicle from sponsors will be deductible for taxation purposes in Australia provided the debt instrument meets the requirements of debt under the debt/equity rules in Division 974 of the Income Tax Assessment Act 1997 (Cth) and other provisions which can affect deductibility do not apply. Dividends payable in respect of shares will not be deductible (unless the equity instrument is characterised as debt under the debt/equity rules) but may be received tax free by the recipient if they are franked. Subject to relevant tax treaties, both interest and dividends will attract Australian withholding tax.

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

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illustration of the pitfalls of relying on relief against forfeiture see *On Demand Information plc v Michael Gerson (Finance) plc* [2000] 4 All ER 734.

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

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

CURRENT ISSUES FOR PROJECT FINANCIERS

Project ratios and cash controls

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

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

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

Project ratios

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

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

- ***Project life cover ratio (PLCR)***. This is the ratio of the net present value of cashflow available for debt service (ie, revenue less operating costs, maintenance capital expenditure and taxes) ("CFADS") over the life of the project to the principal outstanding at that time. In practice it may be more complicated. For example, if the financier is concerned about abandonment costs at the end of an oil project, it might require the NPV to exclude that part of the project covering the last 25 per cent of the project reserves.[13]
- ***Loan life cover ratio (LLCR)***. This is the ratio of the NPV of CFADS over the scheduled term of the loan to the principal outstanding at that time.

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

Other financial ratios which are commonly used, are:

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

- ***Interest cover ratio (ICR).*** This is the ratio of CFADS over the relevant period prior to the calculation date to the project's interest payment obligations.

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

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

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

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

(a) To determine the maximum amount which may be drawn under the facility. This process is referred to as "debt sizing". It is usually expressed as a condition precedent in the credit facility agreement. The procedure is that the financial model is run immediately prior to financial close with the most up to date data available on interest rates and the effect of any interest rate hedging (and any other variable inputs). The financial model must then demonstrate that the project will meet certain cover ratios (usually debt service and loan life cover ratios) over the forecast term of the debt. The size of the debt may be reduced if the debt size is such that the financial model indicates that the project will not comply with these ratios.

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

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

(d) To determine when "cash sweep" should occur (ie, where the project is performing below expectations).[14]

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

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

In most project financings, a computer generated financial model will be agreed between the parties at the commencement of the project which will be used to make the requisite calculation of financial ratios. This is often referred to as the "base case" model and is usually updated at regular intervals over the course of the project to reflect changes in the circumstances of both the project (eg, patronage and capital and operating expenses) and the economy generally (eg, currency and commodity prices and interest rates). Because any

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[14] For more on cash sweeps see "Distribution of project cash flows", below.

change to the inputs to the financial model (eg, on account of changes in commodity prices or interest rates) may be highly contentious, there is often a dispute resolution mechanism in the credit agreement to resolve disputes between the borrower and the financier and their respective agents.

Distribution of project cash flows

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

The order of application of project cash flows may be adjusted during the course of the project to protect the financier. For example, when financing a wasting or deteriorating asset, a financier will be concerned if the borrower exploits the highest grade reserves at the beginning of the project (a process known as high grading), leaving the lower grade reserves for the later higher risk part of the project. To address this risk, many project financings require the borrower to make higher payments than those scheduled if the loan life cover ratio[15] falls below a specified ratio. These higher payments would usually be all of the excess cash flow of the project, or such proportion of it as is necessary to enable the loan life cover ratio to remain at the agreed level.

Other methods commonly used to protect financiers' access to cash flows include "cash sharing" and "mandatory cash sweeps". These techniques are designed to effectively amortise debt at a rate faster than the scheduled amortisation. The concept of "cash sharing" entitles the project financier to receive a share of the cash flow that would otherwise be available for distribution to the project sponsor. So, if on a calculation date, after payment of all amounts having priority of payment in the cash flow waterfall, there is an amount of cash available for distribution to the project sponsor, that amount is shared in agreed proportions between the financier and the sponsor. Cash sharing can sometimes be expressed to apply when the project is performing above a pre-agreed level of DSCR.[16] It is a device intended to accelerate amortisation of the project debt when the project is performing above cash sweep DSCR levels. The additional cash is usually applied in inverse order of maturity (ie, against the last scheduled principal amortisation including any bullet repayment) thereby reducing the financier's risk at the back end of the financing (ie, when there may be a refinancing risk). If the cash is so applied, there is no immediate impact on the borrower's debt service requirements. For this reason, sponsors often seek such cash to be applied pro-rata across all remaining debt service instalments.

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

If the project is not travelling as well as forecast in the financial model, and the forecast DSCR[17] levels are not being met, usually, the project will not be permitted to make distributions (ie, return cash) to the equity parties/sponsors. This often occurs in the initial

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[15] See paragraph "Project ratios", above.
[16] See paragraph "Project ratios", above.
[17] See paragraph "Project ratios", above.

stages of a project. When this occurs, the project is described as being in "lock up". Often when lock up first occurs, the cash locked up will remain in the project (ie, it will stay in the proceeds account). However, if lock up continues for an extended period (say over two or three ratio calculation dates), the financiers will be entitled to "sweep" the cash locked up and apply it in payment of the principal outstanding (again in inverse order of maturity). This is known as a "mandatory cash sweep".

Control accounts

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

- ***Disbursement account*** - this is an account into which all drawings of the facility and any additional equity is deposited. In cases where tight control is required by the financier, withdrawals may, for example, only be permitted against evidence of expenditure, certification of satisfactory completion of works and confirmation that the cost to complete is not more than the undrawn balance of the facility.

- ***Proceeds account*** - this is an account into which all project revenues must be paid.

- ***Debt service reserve account*** - this is an account in which moneys are set aside to enable payments of principal and interest to be made to the financiers, if project revenues are not available.

- ***Capex and major maintenance reserve account*** - this is an account into which cash is paid to cover forecast capital expenditure or major maintenance which will be required on the relevant asset during the term of the financing. Usually the account must be funded out of project cashflows in equal instalments over the period leading up to the time for expenditure.

- ***Ramp up reserve account*** - such an account is increasingly common in projects which have a patronage risk (such as a tollroad or railway) and expect to see patronage increase over time. In the early years, there is a risk that patronage will not increase as quickly as forecast - to protect against this risk, financiers will often require that cash be placed in an account referred to as a "ramp up reserve" which can be used if there is insufficient revenue in early years to cover operating expenses and debt service. This account will usually be funded up front out of the project finance facility. The reserve will then be released into the proceeds account on the earlier of DSCR (both historic and forward looking) having achieved a certain level or a fixed number of months after completion.

- ***Other*** - depending upon the size and nature of the project there may be a variety of other accounts. For example, a compensation account for non-revenue items such as an insurance payment or expropriation or other compensation.

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

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

Market Flex and Material Adverse Change in Market Conditions

So called market flex clauses first appeared in the market in late 1998 in response to crises in global debt markets - they give financiers the ability to reprice the project finance facility or indeed to change its structure or terms. They are now commonplace in the US and to a lesser extent Europe and have found their way into the Australian syndicated loan market. Euro Week in April 2002 summed up the market's reaction to flex as follows:

> *"But as evidence of how far the market has changed towards the lending side, in April 2002, nearly every bank employs market flex where necessary and nearly every corporate grudgingly accepts the clause."*

Prior to the introduction of market flex clauses, banks carried the market risk by committing to pricing and terms. A market flex clause effectively shifts the risk of market changes from the financiers to the borrower. It does this by reserving to the financiers the right to change the pricing of the facility or the terms or structure of the facility to ensure successful syndication in response to changes in the domestic or international financial markets. The ability to change pricing means that financiers can increase the interest rate margin and fees, the structure of the debt (ie, mix of tranches, tenor of tranches and amortisation profile).

It is interesting to compare the impact of market flex clauses in the capital markets and the bank syndication market. In the context of capital markets, underwriters commit to bring an issue to market on the basis of pricing, terms and structure current for comparable credits at the date of issue. In the capital markets, in Australia, usually capital markets issues to occur in the future (ie, under ongoing debt issuance programmes) will not be underwritten in any event until a few days before issue. Pricing for a prospective issue will be quoted as a spread (eg, 80-85bps) over a benchmark rate as the period of exposure to price risk is short. Even in the case of an underwritten issue, standard force majeure clauses (such as those recommended by IPMA) are very rarely invoked. In the bank syndication post flex, the joint lead arrangers commit to underwrite the loan but on the basis that pricing, terms and structure can be varied to ensure successful syndication.

A typical flex clause might be expressed in the following terms:

> *Before the close of syndication, the underwriting banks shall be entitled to change the pricing, structure, tranches or terms of the facilities (otherwise than by reducing the total amount of the facilities) if, having regard to the then prevailing conditions in the domestic and/or international financial markets, they determine that such changes are advisable in order to ensure a successful syndication of the facilities.*

Usually the right to flex is related to domestic or international financial market conditions, pricing of loans generally in the market and availability of funding. However, banks may require flex rights which are triggered by project specific events which, if they occur, could "spook" the syndications market - one example might be legal proceedings challenging authorisations relating to the project or an injunction restraining construction. the concern with such project specific events is that their occurrence may change the risk profile for banks - increased pricing may be needed to compensate for this risk.

These clause are of concern to borrowers as, if financiers exercise rights to flex, this can adversely affect the sponsor's equity return from the project. Drafted in their broadest terms, these clauses can be open ended as to the quantum of pricing changes, the period during which financiers can flex and the scope of changes to structure or terms.

In order to protect themselves, borrowers often seek to impose limits in relation to the exercise of the flex. For example:

- Limits can be imposed in relation to price changes by negotiating which aspect of the pricing can change (eg, interest rate margin only) and by imposing a cap. Alternatively flex can be limited to margin and fees with an aggregate cap.

- The period during which flex can be exercised can be limited by reference to an agreed period (eg, earlier of successful syndication (by reference to final hold positions of joint lead arrangers) and 3 months after financial close).

- Flex rights should not allow financiers to reduce the total amount of the debt. Borrowers can also specify critical covenants which cannot be changed.

- Borrowers can also require financiers to use best endeavours to syndicate without exercising flex, to give reasons for exercise of flex and to take into account the impact of flex on the borrower's equity return.

- Borrowers can require financiers to agree that they cannot reprice for deals that are already in the market where pricing is known at the date of syndication.

- Finally, financiers can be required to flex in a particular order - for example, underwriting fees to be flexed first (as they are a "one-off" cost) before margin is flexed as margin is an ongoing cost over the life of the project).

Generally speaking, the Australian syndicated loan market has been robust and financiers have exercised their rights under such clauses only rarely in Australia. It is more likely to be exercised if debt is being raised within and outside Australia and the pricing of offshore facilities is flexed. Flex may also be considered where a project runs into difficulty.

Some interesting legal issues arise in respect of flex clauses. Assume banks exercise flex right and, as a result, changes are required to the finance documents. Does the flex clause require the borrower and other parties to execute documents needed to amend the finance documents. If the borrower refuses to sign documents, what remedies are available to banks? The traditional legal remedies are specific performance (ie, a court order directing a party to do what it agreed to do) or damages (ie, monetary compensation for loss). What is the loss suffered by banks if they cannot syndicate successfully and reach their final hold position. It is not entirely clear that banks could get an order for specific performance.

Another interesting development is that at least in the European and US markets, flex clauses have been used which allow for a reduction in the margin paid on loans or bonds according to the level of demand among lenders. This has occurred in the case of LBO or corporate facilities rather than project finance facilities.

Another device used by financiers to protect themselves is a clause which gives them the ability not to fund at all if a material adverse change ("**MAC**") has occurred. Where the MAC clause is objective (ie, not expressed to be in the financier's opinion), whether such an event has occurred will be a question of fact to be determined by a court. If the clause is expressed as a matter for the financier's opinion, it is likely that courts will require the financier to have formed its opinion in good faith based on reasonable grounds.

MAC clauses which focus on the borrower will not necessarily cover market related events. In one case (Tempus), the UK Panel on Takeovers and Mergers found that the events of 9/11 did not meet the degree of materiality required to constitute a material adverse change in long term prospects of the subject company. Such clauses generally need to provide an ability to terminate commitment if there is a MAC in domestic, international money, debt or capital markets which might materially and adversely affect the ability of underwriters to syndicate the facility. Given the current unpredictability of world events, banks need to consider MAC clauses carefully to ensure they cover specific events of concern. If not, a court could conclude that consequences of political events are in fact foreseeable and a MAC clause is not triggered.

Care needs to be exercised by sponsors where such clauses are included - in particular, project risks assumed by financiers (such as market risk) should not be a basis for withholding funding (or indeed exercising default rights) and should be excluded from the scope of the clause

Material Adverse Effect Events of Default

Material adverse effect events of default are invariably included in project finance documentation today. They usually follow a long "shopping list" of specific events of default. The usual reason given for their inclusion is to ensure that there is a "trigger" allowing the financiers to exercise their rights in unforeseen circumstances which have led, or are likely to lead, to a deterioration in the borrower's creditworthiness.

These types of clauses have come before Australian courts on a number of occasions. On the basis of these decisions, it is possible to draw some guidance as to how these clauses will be applied by the courts in practice. In drawing conclusions from these decisions, care needs to be taken because, in each case, the court is interpreting wording in a specific material adverse effect clause with regard to particular facts.

The relevant decisions are:

- *Pan Foods Company Importers and Distributors Pty Ltd and Others v Australia and New Zealand Banking Group Ltd and Others*[18]
- *Vision Telecommunications Pty Ltd v Australia and New Zealand Banking Group Ltd*[19]
- *Canberra Advance Bank Ltd and Another v Benny and Others.*[20]

In *Pan Foods*, the High Court considered a clause in the following terms in the bank's General Conditions of lending:

> "(j) ([M]aterial adverse effect) [I]f an event occurs or circumstance arise which, in the opinion of the Bank may have a material adverse effect on the business, assets or financial condition of the Customer or a Relevant Company or on the ability of the Customer or a Surety to perform its obligations under any Transaction Document ..."[21]

ANZ contended that an event of default had occurred under this clause when the bank received "disastrous" trading results for Pan Foods for the March quarter 1994 and subsequent information received from an investigating accountant confirmed this situation.

In relation to whether the facts fell within clause 10.1(j), Gleeson CJ, McHugh and Hayne JJ noted that:

> *"An Event of Default within the meaning of 10.1(j) of the General Condition occurred. When Pan Food's facilities came up for review in 1994, an investigating accountant was appointed to report to the bank. It became obvious that Pan Foods was incurring large losses. The bank officer in charge of the account told his superiors that the company was performing "disastrously". The accountant expressed the opinion that, if the bank enforced its security, there would be a substantial shortfall. The evidence makes it plain that circumstances had arisen which, in the opinion of the bank, had a material adverse effect on the business, assets and financial condition of Pan Foods and on its ability to perform its obligations to the bank.*
>
> *It was submitted that there was no specific evidence of the formation of such an opinion. In truth, on the information before the bank, no other opinion was reasonably available, and what was said and done by the officers of the bank makes it clear that they held such an opinion.*

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[18] (2000) 170 ALR 579
[19] [2001] WASC 139
[20] (1993) 115 ALR 207
[21] (2000) 170 ALR 579 at p 586

That entitled the bank, under General Condition 11.1(e) to declare (that is, to communicate to its customer an expression of its will) that the moneys owing by the customer were immediately due and payable. It did this by giving a notice demanding payment."[22]

Callinan J in his judgment noted that:

"The evidence to which Kenny J.A. referred and which has been summarised, of the parlous state of Pan's business, including its deteriorating trading position and the unmarketability of its assets, amply entitled the bank (Mr Bew) to form the opinion that Pan was carrying on the business at a loss and that further prosecution by it of the business would endanger the bank's security, and the bank had in fact formed that opinion."[23]

Like most loan agreements, there was a clause which enabled the bank to declare the principal outstanding once an Event of Default had occurred. In this regard, Callinan J noted that:

"... the declaration which the clause requires is a clear expression of the reaching of a state of satisfaction of the mind of the respondent bank that a relevant event of default had caused and that the bank had resolved to and by taking steps that it is entitled to take consequent upon that. The fact that the bank had so acted indicates the formation of the requisite state of mind. A declaration was therefore implied in the decision of the bank to give notice and giving of the notice with the content, and in the form that it did.[24]

Kirby J also made observations in this case about the principles to be applied in the construction of commercial documents comprising agreements for loan. His Honour noted that:

" ... the documents in question in the appeal are those agreed to by a large banking corporation (the bank) in relation to the extension of substantial financial credit to the other party, a commercial corporation (the company) engaged in business with a view to profit for its shareholders ... ".[25]

His Honour then considered the principles applicable to contracts of suretyship and went on to say:

"This appeal is not the occasion for the reconsideration of all of the matters debated in Tricontinental. But it is an occasion to restrain any attempt to push the strict approach adopted in that case (and other cases) beyond contracts of suretyship into ordinary loan agreements between financiers and business enterprises operating for profit. Whatever might be the approach suitable to agreements between other parties for other purposes, those of the commercial kind must be approached "fairly and broadly, without being too astute or subtle in finding its defects."[26]

"... ... ...In my view, such documents should be construed practically so as to give effect to their presumed commercial purpose and so as not to defeat the achievement of such purposes by an excessively narrow and artificially restricted construction ... ... as between a commercial enterprise and a finance provider, such as a bank, the law should be the upholder of agreements. It should eschew artificialities and excessive technicality for these will not be imputed to the ordinary business person. Business is entitled to look to the law to keep people to their commercial promises."[27]

Based on the Pan Foods case, we can identify the following principles:

[22] (2000) 170 ALR 579 at p 580
[23] Ibid at p 592
[24] Ibid at p 592
[25] Ibid at p 581
[26] Ibid at p 582
[27] Ibid at p 584

(a) there must be evidence to support the material adverse change. The Court found, based on the evidence, that there had been circumstances which had a material adverse effect on the business, assets and financial conditions of Pan Foods and on its ability to perform its obligations to the bank;

(b) in relation to the issue of whether there was evidence that the bank had formed the relevant opinion, Gleeson CJ, McHugh and Hayne JJ commented that, on the information before the bank, "no other opinion was reasonably available and what was said and done by the officers of the bank make it clear that they held such an opinion."[28] This suggests that, even if there is no direct evidence as to formation of the opinion, the Court will look at what opinion a person might reasonably form in the circumstance and conduct (of the bank's officers) can satisfy the requirements that the relevant opinion was in fact held. As noted below, other Courts have taken a stricter approach on the issue of the formation of the relevant opinion by the lender;

(c) from the comments of Kirby J., that bank loan agreements should generally speaking be construed practically and upheld and not subject to artificial or excessive technicality.

The comments made by the High Court in the *Pan Foods* case indicate that, contrary to what is often asserted during the course of negotiating loan agreements, material adverse change clauses will not be construed technically or strictly but will be given a practical interpretation by the Courts. Therefore, there is a need when acting for borrowers to focus on the language of the clause, the factors which should be excluded from the clause and even an opportunity to cure the adverse change in certain circumstances.

In *Benny*, the Federal Court of Australia also made observations in relation to the approach to material adverse change clauses and in regard to the appointment of receivers. In that case, the Court considered whether particular matters could constitute a change in the financial condition of a person. The matters were:

(1) a difference between cashflow projection for the relevant business received from two sources;

(2) the borrower's desire to change to interest only payments;

(3) omission by the borrower of rental payable to another person in cash flow projections;

(4) the borrower's failure to gain a further injection of funds for advertising by sale of certain goods; and

(5) the threat to wind up an associated person.

The Court noted that the bank carried the onus of establishing the existence of the relevant circumstances and that they constituted a change of the relevant kind and then proving that the lender, through its appropriate officers, directed its mind to that matter and formed the necessary opinion.

The Court found that:

(a) mere projections do not constitute a change - without more evidence, it would be unsound to rely on two differing projections as evidencing that a change in financial condition had occurred;

(b) a desire to change to interest only repayments, and the other matters referred to in (3) and (4) above were matters of concern but they did not per se reflect a change of the requisite kind; and

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[28] Ibid at p 581

(c) the mere service of a statutory notice of demand under section 364 of the Companies Act, whilst a "most serious occurrence in the commercial life of any company ... [which] could lead ... to a statutorily identified inability to pay its debts ..."[29] did not constitute proof of change in a person's financial condition.

It is interesting to note that, whilst in *Pan Foods* the High Court found there was clear evidence of a material adverse change through a disastrous trading loss in a quarter, inadequate cashflow and an inability to restructure, the Court did not find this to be the case in *Benny* at least in relation to the 5 circumstances referred to above.

The Federal Court in *Benny* also considered the proposition that a party who takes a step pursuant to a contract is entitled to justify the taking of that step if the objective facts justifying the taking of that step existed at the relevant time even though that party, at the time that step was taken, did not know of those facts (*McMahon's* case). Whilst the Court found judicial support for that proposition, it determined that the principles were not applicable in the case before it.

In *Benny*, after the bank had appointed a receiver, it discovered certain circumstances which could be relied on in relation to the material adverse change event of default. The clause under consideration, as was the case in the *Pan Foods* case, required the lender to form an opinion. In relation to relying on subsequently disclosed information Neaves, Miles and O'Loughlin JJ observed that:

> *"... for there to be an event of default under sub-clause 12(8) that would trigger the appointment of a receiver, the lender must form the relevant opinion. Without that opinion, that particular subclause does not become operative. If the bank did not know of the poor trading results or of the excess of liabilities over assets until Mr Taylor gave it the information, it stands to reason that the date on which the information was received was the first occasion upon which the bank (through its officers) could have formed the necessary opinion; but that date was, of course, some months after the receiver's appointment. Even if the accuracy of Mr Taylor's investigation be accepted, they nevertheless did not constitute a breach that existed at the time when he was appointed as receiver. Hence, no such breach can be relied on by the appellants to support the validity of the appointment."*[30]

The case is also of interest as it was also argued by the bank that a failure to supply financial statements, in breach of an undertaking to do so, was an event of default. The respondent complained that this failure was an inconsequential breach and that it should not give rise to an event of default. The Court dismissed this argument noting that:

> *"Whilst such a attitude is understandable, it is not to the point; in fact it cannot be permitted because of the strict provisions of clause 12 of each deed of charge. That provision makes it clear that delays and waivers do not constitute any impediment to the lender's rights to enforce its security upon the happening of any event of default".*[31]

So, notwithstanding that the Court did not allow the subsequently discovered information to be relied on for the purpose of the material adverse change clause, the Court found that the failure to supply financial statements, even if immaterial, was an event of default which entitled the bank to appoint a receiver.

In *Vision Telecommunications*, the Supreme Court of Western Australia had to consider whether the bank had acted properly in refusing to advance funds on the basis that, in the bank's opinion, there had been a material adverse change in the borrower's financial condition such as was likely to prejudice its ability to pay the loan.

[29] (1993) 115 ALR 207 at p 217
[30] Ibid at p 219
[31] Ibid at p 220

Pidgeon AUJ found that there had been a material change in the borrower's financial condition. As to the issue of whether the change was an adverse one, His Honour noted that the default clause did not provide for an objective judgment - rather the default condition was met if "in the opinion of the bank", the adverse change was a change in the financial condition as was likely to prejudice the ability to meet the loan. His Honour found that the relevant bank officers had formed the view required by the clause and that that view had been honestly formed and was based on reasonable grounds.

The borrower argued that, in order to have a reasonable view, the bank was required to make an inquiry as to what the borrower's future might be in light of certain negotiations that were taking place. His Honour found that, if there was a requirement for the bank to form a view that is "reasonable", it does not extend as far as making inquiries of the type submitted prior to making a decision within the terms of the default clause.

Pidgeon AUJ found that the relevant bank officers had formed the opinion required by the default clause and that they were of sufficient seniority such that their view was the bank's opinion within the meaning of the clause.

However, the borrower also argued that when the bank refused to advance funds, the bank officer dealing with the account had not turned his mind to the question of whether there was an Event of Default within the clause - rather he had prepared a report and sent it to his supervisor in Head Office who then formed a view about the existence of an Event of Default. Notwithstanding this, His Honour found that the Event of Default was the existence of the actual circumstances on the relevant date. His Honour said:

> *"These circumstances ... existed on 6 March. Those circumstances must have the quality that they, in the opinion of the [bank], are a material adverse change and are likely to prejudice the ability of the [borrower] to pay the loan. The circumstances had this quality, because when the officer of the bank directed her mind to that question she formed that opinion. It does not matter that the opinion was formed later because the forming of the opinion meant that the circumstances existing as at 6 March had that quality. The opinion was based on the circumstances as they existed at 6 March. I do not consider that the Event of Default is the bank forming the opinion. It is the existence of circumstances with the quality mentioned and they existed on 6 March."*[32]

His Honour noted that this was consistent with what was said by Kenny JA in *Pan Foods* at first instance when Kenny JA had said that in the circumstances of the case, it did not seem to matter whether or not the bank in fact relied upon that clause at the time it issued the notice - the bank was entitled to justify the dealing of the notice of demand by reference to the agreement upon the basis that the facts which justified that step existed at the time the step was taken, though the bank did not know of the justification at the time. This finding was reversed on appeal.

On this basis, His Honour found that an Event of Default existed on the relevant date and that the bank had not breached the agreement in refusing to advance funds.

The principles applied by Pidgeon AUJ in *Vision Telecommunications* differ from those espoused by the High Court in *Pan Foods* and also from the approach taken by the Federal Court in *Benny.*

- As noted above, the majority judgment of the High Court in *Pan Foods*, in response to a submission that there was no specific evidence of formation of such an opinion, found that, on the information before the bank no other opinion was reasonably available and that the conduct of the bank's officers made it clear they had such an opinion. This suggests that lack of direct evidence as to formation of the opinion is not critical provided the objective evidence would support such an opinion and the bank conducts itself consistently with having such an opinion.

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[32] [2001] WASC 139

- In *Vision Telecommunications*, Pidgeon AUJ found that it was sufficient if the factual circumstances existed at the relevant date even if the bank's opinion about those circumstances was not formed until later.

- In *Benny*, the Federal Court found that if the bank did not have the relevant information at the time it acted, it could not have formed the requisite opinion and without that the default clause was not operational. Contrary to the approach in *Vision Telecommunications*, even if the circumstances existed, if the bank did not know about the circumstances and could not have held the relevant opinion, the clause was not triggered.

It seems then that, in order for a bank to act under a material adverse change clause which is expressed to refer to the bank forming an opinion:

(a) the bank must have some information at that time about the adverse change in the borrower's circumstances - if it has no such information, it cannot form an opinion and a material adverse change clause requiring formation of an opinion cannot be relied on. In *Pan Foods* and *Vision Telecommunications*, the bank had relevant information about the borrower's position - in *Benny* it did not receive such information until later;

(b) the opinion of the majority judges in the High Court was that, even in the absence of direct evidence of formation of opinion, if the evidence objectively would support such a view, this is sufficient if the bank conducts itself consistently with holding such a view;

(c) if there is information in the possession of the bank as to a change in circumstances, there is no requirement for the bank to make further enquiry and check the view it has formed in order for its view to be honestly formed and reasonably held;

(d) in *Vision Telecommunications* there is a suggestion that default is the existence of the factual circumstances at the relevant time rather than the formation of the opinion. This seems inconsistent with the approach in *Pan Foods* and *Benny*.

Some other matters which need to be borne in mind, when negotiating a material adverse change clause on behalf of a borrower, are:

(a) to seek to exclude from the scope of the clause the relevant project risk which banks have assumed. So, for example, in a tollroad financing, the project financiers have assumed the patronage risk (ie, the risk that traffic will be less than forecast or that traffic will take longer to build up than forecast). Therefore, adverse traffic should not, per se, trigger the material adverse change clause. Likewise in the case of a project which produces a product sold into the market, if project financiers have assumed the price risk, adverse prices per se should not be able to trigger the clause; and

(b) to build in a cure period. This is often resisted by project financiers on the basis that, if there is a fundamental problem with the project, they do not wish to be delayed in taking action. On the other hand, if the sponsors are prepared to spend money to keep the project alive, why is this not also in the interests of the project financiers? There is no right answer - as is often the case, it is a matter for negotiation.

Tax Risk

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

Sponsors will seek to structure their involvement in the project in a tax effective way. This may have both an international aspect and a domestic aspect. The international aspect is particularly relevant in the case of a foreign sponsor. A foreign sponsor will wish to structure its ownership interest in the project so that it is tax effective both offshore and onshore. In

some cases this may mean that the ownership interest is held indirectly through entities in several foreign jurisdictions so that project distributions (whether in the form of interest or repayment of principal on subordinated loans, dividends or trust or partnership distributions) are received in a tax effective way.

For both a foreign or domestic sponsor, the aim will be to use a tax effective project entity. In some cases this may involve the use of a partnership of special purpose vehicles or an unincorporated joint venture (which may be treated as a partnership for tax purposes), neither of which is itself a taxable entity for Australian income tax purposes. This means that profits and losses flow through the vehicle and are taxed in the hands of the partners or joint venturers. This can be contrasted with a company which is a taxable entity and a trust which can be taxed as company in some cases or taxed itself if income is not distributed to beneficiaries.[33] Losses may also be trapped in companies and trusts and not immediately available to the partners or joint venturers.

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

Managing tax risk

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

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

- a tax opinion from the sponsor's tax advisers;
- an independent review of the sponsor's tax opinion; and
- in some cases, a private ruling from the Australian Taxation Office ("ATO"). (For sponsors, the process of obtaining a private tax ruling from the ATO can be time consuming and can lead to considerable delay in the project timetable).

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

(a) s. 51AD of the Income Tax Assessment Act 1936 (Cth) ("ITAA")[34] and Division 16D of the ITAA which can deny tax deductions where government is involved in the project;

(b) the "debt/equity" rules in Division 974 of the Income Tax Assessment Act 1997 (Cth) ("1997 Tax Act") which determine whether an interest is to be treated as in the nature of debt or equity for tax purposes;

(c) the "thin capitalisation" rules in Division 820 of the 1997 Tax Act which determine the level of debt which a project can carry before deductibility of interest is denied;

(d) the new consolidation regime which allows wholly-owned company groups to consolidate their profits or losses and have only the "head company" of the group pay

[33] For more on the legal structure of the project see under the heading "The Choice of Project Vehicle" below.

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

income tax (subject to transitional relief, the consolidation regime replaces the previous rules for transfer of tax losses within company groups); and

(e) Division 243 of the 1997 Tax Act which can deny tax deductions relating to limited recourse debt.

Consequences of tax consolidation

The key concepts of tax consolidation can be summarised as follows:

- Wholly owned corporate groups (including companies, partnerships and trusts) have the option of consolidating for Australian income tax purposes from 1 July 2002. Consolidation is optional, but once made, a decision to consolidate is irrevocable. The ATO does not have to be notified about the election until the group's first consolidated income tax return is lodged. The decision to consolidate is made by the ultimate Australian holding company (Parent) and automatically binds all eligible wholly owned subsidiaries without further action on the subsidiary's part (the "one in, all in" approach).

- The Parent is primarily liable for the group's income tax liability. If the Parent fails to pay a tax liability by the due date, then it and each subsidiary of the consolidated group will be jointly and severally liable for the entire group liability (referable to the period that it was a member of the group) unless either:

  (i) the group liability is covered by valid Tax Sharing Agreements (TSA) in which case if the Parent defaults, the subsidiary is only liable to the Commissioner for the amount allocated to it in the TSA; or

  (ii) the particular subsidiary is prohibited under an Australian law from having the liability.

- TSAs only operate to allocate the group income tax liabilities on default by the Parent. Consolidated groups typically also enter into tax funding/contribution arrangements to deal with ongoing contributions by subsidiaries towards the primary tax liability of the Parent, subvention payments for utilised tax losses and other tax management matters. The tax funding/contribution arrangements may be in the same agreement as the TSA or in a separate document.

- The Parent must provide the ATO a copy of the TSA within 14 days of a written request to do so. Otherwise the group liability is deemed not to have been covered by a TSA and all group members will become jointly and severally liable if the Parent defaults.

- Under AASB draft Abstract 52, a wholly-owned subsidiary in a consolidated group with an existing TSA (including a tax funding/contribution agreement) must recognise any assets and liabilities under the TSA as "tax-related" amounts receivable or payable (instead of tax assets or liabilities). Similarly, payments or receipts under a TSA must be recognised as a component of income tax expense and income tax revenue.

Implications for debt documentation

If financiers are providing debt facilities to the consolidated group with the Parent as borrower and guaranteed by all or substantially all other group members, then tax consolidation has minimal impact. The issue then is entry and exit of group members from the guaranteeing group and the potential retrospective tax liabilities which might attach in such situations (discussed below).

However, tax consolidation has significant consequences which need to be addressed in most project, structured or asset finance transactions, where wholly owned special purpose vehicles (**SPVs**) are established as the borrowers/asset owners, and financiers are relying for recourse from the assets/cashflows of the SPVs (rather than the consolidated group).

These include:

(a) the need to ring-fence the SPV from the tax liabilities of the other members of the consolidated group:

(i) the ideal solution is to create a non-wholly owned SPV borrower where the situation permits, eg in securitisations with orphan SPVs. However, this option is not open if the SPV is incurring valuable tax losses in its early years (eg in a greenfields project) and it would be economically efficient for the SPV's Parent to use those tax losses as and when they arise.

(ii) in these situations, the solution is to impose a covenant package designed to achieve a ring-fencing of the SPV by:

(A) requiring the Parent to implement a valid TSA before electing to consolidate - the difficulty here is to ensure the TSA has a reasonable allocation of group tax liability. As there are limits as to how much financiers can interfere with internally sensitive tax affairs of a company group, one possibility may be to require an opinion from tax counsel or a leading accounting firm as to this aspect. In any event, financiers would not expect any allocation to result in the SPV borrower being worse off than it would otherwise have been had there not been any tax consolidation;

(B) requiring the Parent to make subvention payments to, or indemnify, the SPV for any notional standalone tax losses utilised by the consolidated group. This indemnity can be extended to cover SPV's exposure to income tax in excess of what it would otherwise have paid on a stand-alone basis. Unless supported by cash cover or an externally provided credit enhancement (such as a bank guarantee), this entails factoring the Parent's creditworthiness into the financiers' credit decision (materiality will vary depending on matters such as the period of time the SPV is expected to turn tax-positive versus the tenor of the facilities);

(C) ensuring that tax funding/contribution arrangements are appropriate and do not give rise to a risk of "double payment" by the SPV. In particular, the Parent should ideally be required to make tax payments to the Commissioner before the relevant tax contribution payments are made by the SPV to the Parent;

(D) requiring the Parent to provide a copy of the TSA to the Commissioner within 14 days of a written request (or crafting an event of default if the Parent does not comply). The drastic consequence of what could otherwise be an inadvertent delay (ie, rendering the SPV jointly and severally liable for group tax liabilities) is completely disproportionate and will continue to present difficulties

to borrowers and financiers. A pragmatic fix is for the Parent to indemnify the SPV or financiers for all loss suffered as a result of its failure to comply on time with the Commissioner's request.

(b) a closer inspection of existing covenants - for example, a covenant on the part of the SPV not to consolidate without the financiers' consent may not be sufficient to trigger the necessary consequences because the decision to consolidate is one unilaterally made by the Parent. This would be better cast as an event of default if the SPV becomes part of a tax consolidated group without the consent of financiers;

(c) existing SPV covenants may inadvertently be breached by the implementation of a TSA or its Parent's decision to consolidate. This would be the case if the covenant prohibited the SPV from incurring, or permitting to exist, any liability other than certain permitted liabilities. However, it is questionable whether this would trigger negative covenants preventing the incurrence of financial indebtedness (which are usually defined to capture only indebtedness under financial accommodation-type arrangements and not general liabilities);

(d) in acquisition financings of a target which is part of another consolidated group, mitigating the risk that the target can be liable for its old group's tax liability. This can be done by ensuring a "clean exit" under which the exiting subsidiary can limit its liability for group tax liability for the period during which its exit occurs by:

   (i) exiting before the Parent's due time for tax for that period;

   (ii) paying to the Parent as part of the exit, an amount equal to its contribution for group tax liability for that period or a reasonable estimate thereof; or

   (iii) ensuring that there is a valid TSA for the group and being a party to that TSA.

   However, even this "clean exit" will not protect the exiting subsidiary for any tax liability of the group arising before that current tax period (eg, these may result from amended assessments or defaults by the old Parent in payment of group liability which had already crystallised). Accordingly, the tax warranties and indemnities in a share sale transaction will continue to be the subject of intense negotiation;

(e) tailoring references in financial ratios, cash cascades and cash sweeps to "Taxes" (being a permitted or required disbursement) instead to references to "Taxes and amounts payable in respect of Taxes under TSAs or tax contribution agreements". Similarly references to "Revenues" may need to include "amounts received from the Parent under TSAs or tax contribution agreements".

Withholding tax

Finally, as a result of amendments to the interest withholding tax provisions of the ITAA, most project financings are now structured so as to enable offshore financiers to participate in the financing in a manner which does not cause the borrower to be liable to pay Australian interest withholding tax. Traditional syndicated loans are now structured as loan note subscription facilities. These loan notes are intended to constitute debentures for income tax purposes and to be offered by the borrower/issuer in a manner which satisfies the public offer "test" in s.128F of the ITAA.

The risk of satisfying the public offer test is shared amongst the borrower/issuer and the joint lend arrangers or syndicate agent (as it is the joint lend arrangers or syndicate agent which controls the syndication process). The joint lend arrangers or syndicate agents will give representations and warranties and undertakings to the borrower/issuer in relation to the manner in which the loan notes are offered to other potential financiers. This gives the borrower/issuer the necessary assurance that one of the limbs of the public offer test in s.128F should be met and that it should not be liable to pay Australian interest withholding tax on interest payments to non-resident financiers. Borrowers also will require an exception

from the usual gross up obligation for taxes where the loan notes are held by an "associate", as defined in s.128F, as the withholding tax exemption can be lost in these circumstances.

Project Insurances And Recent Changes In Insurance Markets

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

These will generally comprise construction phase insurances such as:

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

and operational phase insurances such as:

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

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

Since the terrorist attacks in the United States in September 2001, the global insurance market has been in a state of upheaval - in particular, cover for terrorism risk has been progressively withdrawn by insurance and re-insurance companies.[35]. Significant commercial and financial disruption has occurred as a result of the withdrawal of such coverage.

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

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

Key features of the Act are as follows:

- the Act deems a terrorism exclusion in an *eligible insurance contract* to be of no effect in relation to a loss or liability to the extent to which the loss or liability is an

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

eligible terrorism loss. Eligible terrorism loss is a loss or liability from a declared terrorist incident but does not include a loss or liability arising from the hazardous properties of nuclear fuel, nuclear material or nuclear waste;

- eligible insurance contracts are defined as insurance for physical loss or damage to buildings or other structures or works on, in or under land or tangible property contained in or on such property, in each case which is located in Australia and eligible business interruption and public liability insurance cover (whether forming part of a property damage contract or written separately). Other property can be prescribed by regulations. It includes contracts made before the commencement of the Act;

- under section 6 of the Act, a declaration of a terrorist incident can specify a *reduction percentage* applicable to that terrorist incident. A reduction percentage must be specified if the Minister considers that, in the absence of a reduction percentage, the Commonwealth's total liability would be more than $10 billion. Under section 8, if a base amount is payable under a contract because of the terrorism exclusion being void and where the contract was made after 1 October 2003, the insurer is insured with ARPC, then the base amount payable by the insurer under the contract is reduced by the reduction percentage;

- the Act establishes a statutory corporation - the Australian Reinsurance Pool Corporation ("**ARPC**") - which will provide reinsurance cover to insurers for loss arising from a declared terrorist incident. ARPC's functions are to provide insurance cover for eligible terrorism losses and other functions prescribed by regulation. It has power to do all things necessary or convenient to perform its functions;

- the Act sets out the circumstances in which the Minister must declare that an act constitutes a declared *terrorist act* for the purposes of the Act - an act can only be declared if it occurs after the startup time (ie, 1 July 2003). The Minister is required to seek advice from the Attorney-General before making such a declaration. The act must have happened in Australia and an act will not be taken into account if the Minister is satisfied that it is an act of war;

- the Treasurer will be able to direct the ARPC on the premiums to be charged for the reinsurance[36] and also as to the extent to which risk is to be retained by the insured under a contract of reinsurance with ARPC;

- the Commonwealth guarantees the due payment of money by ARPC to any other person.[37] The Act contains an appropriation of the Consolidated Revenue Fund to meet the Commonwealth's liabilities under its guarantee and to meet any borrowing by ARPC from the Commonwealth.

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

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

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

A transition period, commencing from the Scheme's start up date of 1 July 2003, will apply, as terrorism risk coverage will be deemed into existing contracts without any charges for such coverage being levied until the date of renewal. The ARPC will only collect reinsurance premiums for those eligible insurance contracts entered into on or after 1 October 2003 to give insurers sufficient time to change their systems. In respect of policies entered into during the period from 1 July 2003 to 1 October 2003, reinsurance will be provided by ARPC free of charge[38] in order to avoid forcing a liability onto insurers for which they cannot charge additional premiums to offset the new risk.

The Government's objective is to operate the Scheme only while terrorism cover is unavailable commercially on reasonable terms. As a result reviews of the Scheme and the global terrorism risk reinsurance market will be conducted every two to three years, to assess the state of the market and the possible wind up strategy of the Scheme. Components of the Scheme, including pricing, classes of insurance required to provide terrorism risk cover and level of underwriting available are deliberately flexible, not being set in legislation, in order to encourage the re-emergence of the commercial market.

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

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

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

International Financial Reporting Standards - impact on debt documentation

The imminent adoption of the International Financial Reporting Standards (which includes existing International Accounting Standards) (**IFRS**) in Australia and the new tax consolidation regime have been focal points of change for business in Australia. Banks need to consider the impact of these two recent developments on existing and future debt facility documentation, and in particular, on financial ratios and covenants.

Reporting entities must prepare financial reports in compliance with accounting standards and regulations made by the Australian Accounting Standards Board (**AASB**). Generally speaking, this includes all public companies, large proprietary companies, registered schemes and other forms of disclosing entities: Chapter 2M.3 of the Corporations Act. With AASB's adoption of IFRS in Australia, reporting entities will have to prepare IFRS-compliant financial reports for reporting periods beginning on or after 1 January 2005. Entities with a 30 June year end will have to compile IFRS-compliant data as from 1 July 2004 in order to present prior year comparatives for their 30 June 2006 financial reports.

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

Most debt facility documents include:

- obligations on the borrower to prepare accounts in accordance with Generally Accepted Accounting Principles (**GAAP**). GAAP may be defined as accounting standards applicable from time to time in a particular jurisdiction (**moving GAAP**) or accounting standards applicable as at a particular date (eg, the date of the facility agreement) or which formed the basis for preparing the initial set of financial statements approved by the financiers (**frozen GAAP**).

- financial ratios and covenants (eg, balance sheet ratios such as Gearing and cashflow ratios such as Debt Service and Interest Cover Ratios) are usually based on data derived from financial statements prepared in accordance with GAAP. The moving GAAP approach means that these ratios and covenants may be significantly affected by the introduction of IFRS despite there having been no substantive change to the underlying financial wellbeing of a company. In contrast, the less common frozen GAAP approach has the advantage of preserving the basis for calculating these ratios and covenants, although in practice, this comes with the administrative burden for the borrower of having to maintain two sets of accounts.

Set out below are some of the key IFRS changes which would impact upon financial ratios and covenants. They are by no means exhaustive.

Re- classification of financial instruments

Under IAS 32, some financial instruments currently classified as equity (such as reset preference shares) will be re-classified as liabilities. An instrument will be a liability if, for example:

- the issuer is or can be required to deliver either cash or another instrument to the holder or to exchange financial assets or liabilities with the holder under conditions which are potentially unfavourable to the issuer; or

- the holder of the instrument can put it back to the issuer for cash or another financial asset.

This classification will determine also the treatment of interest, dividends, losses and gains. The equity and liability components of compound instruments must be accounted for separately.

Accounting for financial instruments at fair value

Under IAS 39, all financial assets and liabilities (including derivatives) will need to be categorised appropriately. It will generally be harder for transactions such as debt factoring and securitisation to qualify for off-balance sheet treatment. Financial assets and liabilities will have to be recognised on balance sheet (mostly at fair values) unless they meet IAS 39's strict derecognition rules. However IAS 39 will only apply prospectively such that non-derivative financial assets and liabilities that were derecognised prior to 1 January 2004 will remain derecognised.

Non-financial institutions may find it difficult to comply with the strict criteria applying to hedge accounting and so, are likely to have to mark to market their derivative positions. This will increase volatility in reported earnings as unrealised gains or losses will be recognised in the income statement on an ongoing basis. Existing hedges that do not qualify for hedge accounting under IAS 39 will have to discontinue hedge accounting.

Treatment of intangible assets

Australian companies currently enjoy a degree of flexibility with respect to how intangible assets are recognised and measured. However, with IAS 38 and related proposed changes

governing intangibles, items on a company's balance sheet may have to be derecognised and revaluations will be limited.

Intangibles that are currently on balance sheets but do not qualify for recognition under the new standards will be written down to costs or derecognised altogether (in the case of some internally generated intangibles such as brandnames, mastheads and internally generated goodwill). Restrictive revaluation requirements for intangibles mean that those currently held at fair values for which there is no active market must be carried at cost in the future.

IAS 38 will apply retrospectively such that billions could disappear from corporate Australia's balance sheets upon first time application of IFRS.

Expensing shares and options to employees

Under a new IFRS standard, companies will have to recognise an expense in the income statement where equity or equity-based instruments are provided in exchange for goods or services. Until now, Australian companies are able to issue shares or options to employees as part of their remuneration without recognising any expense. With IFRS, the expense will be recognised when the services are received over time and will be measured by reference to the equity instrument's fair value and if no observable market value exists, estimated by using an option-pricing model.

Post-employment benefits

IAS 19 requires ongoing recognition in the balance sheet of the net post-employment asset or liability at fair value. The asset or liability equates to the difference between the amount of the future obligation under the plan and the fair value of the underlying plan assets. For companies with defined benefit schemes, this means that actuarial gains and losses will be reflected in the income statement. The amount of expense is the cost of providing future benefits under the defined benefits plan for services rendered in the current and past periods.

Financial ratios and covenants

Financial ratios and covenants are used for a variety of reasons in debt documentation. These include:

- pricing - where margins or pricing grids are linked to various financial ratios and covenants;
- conditions precedent and debt sizing (which depend on minimum coverages being established);
- ongoing undertakings or as events of default;
- triggers for lockups and cash sweeps; and
- determining thresholds for adding or removing guarantors or security providers for the facilities.

Where a company is required to comply with moving GAAP, IFRS may affect the component parts which make up these financial ratios and covenants. Each must be analysed on a case-by-case basis.

Balance sheet ratios

Balance sheet ratios (such as Gearing) and covenants (such as maintenance of a minimum Net Tangible Assets or Net Worth level) measure the financial status of a company at a point in time. Ratios and covenants which use Total Assets or Total Liabilities derived from a company's balance sheet will automatically import all of the IFRS changes and could be

significantly affected. However, if a Gearing ratio was based on Debt to Total Capitalisation measured as Debt plus Equity (being paid-up capital, retained earnings and perhaps certain reserves), there would be less of an impact.

Some ratio components could be self-insulating in nature. For example, those which use Total Tangible Assets would not be impacted by any write-offs or derecognition of intangibles required by IAS 38. Similarly, ratios which disregard Asset Revaluation Reserves or revaluations made after financial close would be less affected. Likewise, if "Debt" in a Gearing ratio is defined to exclude all contingent or marked-to-market liabilities under hedging instruments, IAS 39 would have less of an impact.

Cashflow cover ratios

Cashflow cover ratios (such as Debt Service or Interest Cover ratios) measure the robustness of operating cashflows of the business to service debt over a particular period of time or over the life of the loan/project (eg, Loan Life Cover Ratios and Project Life Cover Ratios). They can be based on historical or projected performance, and are measured periodically (be they 3, 6 or 12 month periods).

Interest Cover Ratio measures the extent of coverage provided by Cash Available for Debt Service (**CADS**) over a period when compared to the interest obligations of the borrower for that period.

CADS can be based on purely cash concepts (using cash revenues and other incomes) in which case it will largely be unaffected by IFRS. However, CADS is often defined by reference to a mixture of cash and accounting concepts. For example, if CADS is defined as EBITDA less capex less taxes, then EBITDA could be materially affected by IFRS changes such as employee option expensing, marking-to-market of hedge positions and gains or losses under defined benefit schemes, not only on a one-off basis but also on an ongoing basis.

To the extent CADS was an attempt to measure the available cashflow of a company, then one way of achieving this post-IFRS implementation is by eliminating the IFRS-induced non-cash items incorporated within the EBITDA concept in CADS.

Practical considerations

For borrowers in the process of negotiating covenants, the impact of IFRS can be neutralised somewhat by appropriate specification of the components of the financial ratios and covenants. One alternative is to seek to use the frozen GAAP approach (but with increased administrative costs of having to maintain two sets of accounts). If this is not possible, then a moving GAAP approach can potentially be combined with a review/renegotiation mechanism in respect of the first set of IFRS-conforming reports.

For borrowers currently presenting financial ratios and covenants in line with moving GAAP, continuous monitoring and review of the potential impact of these developments on their existing financing covenants are the order of the day, coupled with pro-active measures such as having early discussions with financiers to determine the best solution to neutralise any material adverse impact.

All other things being equal, financiers should be prepared to be flexible and co-operative if, as in the case of the IFRS changes, merely the presentation of financial reports has changed and not the borrower's underlying creditworthiness.

PROJECT FINANCE DOCUMENTATION

Security trust deeds

In Australia, the practice has developed of project securities being held by a security trustee under a security trust structure. This has the principal advantage that different classes of

creditors can each receive security without the need for multiple securities and complicated priority agreements. Those secured by the security trust structure may include the financers, bond holders (through the trustee for those bond holders), subordinated debt providers, and hedging counterparties (but not the government in respect of its obligations under a concession deed in an infrastructure project). If the security trust deed and its supporting securities are appropriately drawn, they may secure not only the initial project transactions but also refinancings with consequent savings of documentation costs and stamp duty.

The security trust deed will generally provide for:

- the establishment of a trust (which will vest within the requisite perpetuity period);
- the property subject to the trust and the terms upon which the security trustee will hold the trust property;
- the order of priority in which the proceeds of realisation of security are to be distributed between the different classes of creditors and among financers in the same class;
- a voting regime to apply in relation to the giving of directions by the beneficiaries to the security trustee and, in particular as to the circumstances in which the securities may be enforced; and
- standard provisions for the protection of the security trustee (these are similar to the agency provisions in a syndicated facility agreement).

The security trust deed will ordinarily be structured to confer little discretion on the security trustee, so as to minimise the risk of the security trustee having a conflict of interest as a result of the differing interests of beneficiaries and so as to maximise the control of the senior creditors. There are many other issues for negotiation. The voting rights of parties in different circumstances is one issue which needs to be considered carefully. Examples of circumstances where this issue may arise include:

- where there are different lenders whose exposure changes over time (eg, senior bank debt is reduced over time and other creditors such as bond holders have a constant or increased exposure which affects the composition of the class of creditors who can pass a resolution to take action);
- where there are different groups of lenders providing different types of debt - for example, long term bondholders providing core term debt and financiers providing construction financing for an expansion - the different classes of lenders may have divergent interests so there may be a need for a regime which provides initially for a higher voting threshold before action can be taken, a standstill period for lenders to consult and decide upon a way forward followed by a lower voting threshold thereafter to allow action to be taken if agreement cannot be reached;
- whether or not hedging counterparties should be entitled to vote prior to closing out their hedging contracts and, if so, how their voting rights should be calculated; for example, by reference to their full mark to market exposure?; and
- the existence of a guarantee from a credit wrap provider (eg, who insures payment of principal and interest on bonds) will require that bondholders voting rights are exercised by the credit wrapper for so long as bondholders are kept whole.

In order to avoid the security trust being subject to *ad valorem* conveyancing duty as a trust, it is usual for the security trust deed to be executed in a jurisdiction which imposes only fixed or nominal stamp duty on deeds of trust.

Additionally, the security trust deed is usually drafted in as flexible a way as possible, as a change to the beneficiaries' rights under the security trust deed may amount to a resettlement

of trust, with a consequential stamp duty liability. A variation to a trust which effects a resettlement may be liable to *ad valorem* stamp duty, often in more than one jurisdiction, for up to 5.5 per cent of the value of the trust assets. The value of the beneficiaries' security interest in the security trust deed is problematic, but the scale of the potential liability dictates that a cautious approach be adopted.

Intercreditor deeds

Intercreditor deeds are not security interests but perform an important role in any project financing where funding involves different types of debt from a variety of debt providers (e.g. senior debt, mezzanine debt and/or capital markets instruments).

The intercreditor deed will specify:

(a) if there are securities granted to different categories of financers, the priority of those security interests and, in some cases, the priority amounts of those security interests;

(b) if there is a common set of securities, the priority or ranking of claims of different categories of financers against the shared securities;

(c) if there is a mezzanine (e.g., subordinated) funding component, the terms of subordination and other principles to apply as between the senior debt providers and the mezzanine debt providers;

(d) if there are hedging counterparties, the rights of those counterparties to close out their hedging contracts and to vote in relation to enforcement of the security; and

(e) the release by mezzanine debt providers of their claims against the project vehicle upon enforcement of the security by the senior debt where the shares in the project vehicle have been sold.

In appropriate cases, the security trust deed and intercreditor deed can be combined in a single document and provisions such as those relating to the control accounts and cash flow waterfall, in which all financers have an interest, included in that document.

Issues for mezzanine financiers

Mezzanine finance has become an important source of funds when considering financing a project. Where senior lenders are only prepared to lend at certain levels to a project, mezzanine financiers can cover the funding gap between senior debt and equity. This form of funding will be more expensive than senior debt as it carries with it a higher level of risk of non-payment.

Often it is asserted that mezzanine debt is to be deeply subordinated and should have no rights as against senior lenders. However, there are a series of issues which mezzanine lenders need to address to ensure that their rights are preserved vis a vis senior lenders and that their position is not adversely affected by subsequent events or matter agreed between senior lenders and the borrower. Mezzanine financiers can find themselves with a substantial amount of bargaining power in a distressed asset scenario if they have taken steps to preserve their rights.

Enforcement restriction period

Invariably the senior lenders will have a prior security interest over all assets and undertakings of the borrower (and all related companies in its group) and the mezzanine financiers will have a security interest ranking immediately behind that granted to senior lenders. Usually, the senior lenders and the mezzanine financiers will be beneficiaries under a common security trust deed with mezzanine financiers ranking second behind senior debt. However, whilst enjoying the benefit of being secured, mezzanine financiers will be subject to an enforcement restriction period being the period from the date of the financing until the

earlier of the repayment in full of senior debt or the maturity date of the mezzanine financing - during this period the rights of mezzanine financiers will be curtailed as against the rights of senior lenders.

The rights and restrictions upon mezzanine financiers will usually include the following:

(a) the right to call an event of default (whether during or after the enforcement restriction period);

(b) the right to accrue default interest on both the mezzanine principal amount and any overdue interest, at a higher rate (whether during or after the enforcement restriction period). Such interest will only be able to be paid, however, as permitted by the cash cascade;

(c) a right to accelerate the mezzanine debt:

  (i) on acceleration or enforcement by senior lenders;

  (ii) if an event of default occurs after the enforcement restriction period;

  (iii) if an insolvency event occurs in relation to the borrower or any security provider during or after the enforcement restriction period;

  (iv) during or after the enforcement restriction period where:

    (A) the borrower is in breach of its payment obligations to mezzanine financiers, provided that the mezzanine financiers have given prior written notice to the senior lenders of the breach and provided to the senior lenders an additional cure period to rectify the breach; or

    (B) if the borrower obtain financial accommodation in breach of any agreed refinancing regime; or

    (C) if any person disposes of any shares in the borrower (other than permitted disposals as agreed) or the borrower disposes of all or substantially all of its assets, or any steps are taken for the purposes of any such disposal, without the prior written consent of the mezzanine financiers other than, in any case, on enforcement of the Securities; and

(d) a right to enforce the security (subject to the rights of the senior lenders):

  (i) on enforcement by senior lenders; or

  (ii) if an event of default occurs after the enforcement restriction period; or

  (iii) after permitted acceleration under paragraph (c) above.

Preservation of rights of mezzanine financiers

In order to preserve their "day one" rights under the financing documents into the future and to ensure that their position is not adversely affected by future changes agreed between the borrower and senior lenders, mezzanine financiers need to ensure that the security trustee, senior lenders and borrower undertake in favour of the mezzanine financiers that they will not, without the agreement of the mezzanine financiers make any amendment to:

- the security trust deed;

- maturity date, repayment profile, margin, financial covenants or lock up regime contained in the senior debt documents where that amendment adversely affects the rights or interests of the mezzanine financiers;

- specified definitions in the senior finance documents which can impact on the cashflow to mezzanine financiers, the activities permitted to be undertaken by the borrower or the senior and mezzanine finance documents or rights thereunder or any definition which includes the word "senior", "subordinated" or "mezzanine" in the finance Documents and;

- any provisions of the securities relating to payment and sharing before enforcement and distribution after enforcement or any other provisions of any security if as a result of the amendment any mezzanine financier would cease to be a beneficiary under the security trust deed or would become unsecured in respect of all or any part of its exposure; or

- the cash cascade.

In addition to these rights, mezzanine financiers should retain the ability to exercise the following rights by way of injunction or other equitable remedies (other than claiming equitable damages or loss) at any time either during or after the enforcement restriction period:

- to seek declaratory relief;

- to enforce the undertakings given by the security trustee, senior lenders and borrowers (as referred to above);

- to enforce any refinancing restrictions;

- to enforce any covenants applying exclusively to the mezzanine financiers but not senior debt and which are not inconsistent with the senior debt terms; or

- to enforce a covenant to pay money if, and only if, the borrower has funds available to pay mezzanine financiers and such payment would be permitted to be made under the terms of the cash cascade and the borrower fails to make such payment;

Waivers by senior lenders

If senior lenders have waived the application of any covenant or an event of default in relation to senior debt or granted any consent under the senior debt documents, then an equivalent waiver or consent is usually deemed to have been given by the mezzanine financiers.

However, such a waiver or consent should not be deemed to have been given by the mezzanine financiers in relation to waivers relating to:

- the borrower's obligations to pay the mezzanine financiers; or

- matters where mezzanine financiers have specified rights under the finance documents to act in relation to acceleration, enforcement of security, restrictions to changes to finance documents and restrictions relating to the acts of the security trustee; or

- any covenant imposing restrictions on the ability of the borrower to incur additional financial indebtedness or any provisions imposing restrictions on the ability of the borrower to dispose of all or substantially all of its assets or restrictions on the disposal of shares in the borrower (other than permitted disposals); or

- any covenants applying exclusively to the mezzanine finance but not senior debt.

Also, mezzanine financiers should have a unilateral right to determine whether a condition precedent has been satisfied under the mezzanine financing documents and whether an event of default or potential event of default (as defined in the mezzanine financing documents) has occurred for the purpose of causing interest at a higher rate to accrue under the mezzanine financing documents.

Events of default and enforcement of security

If an event of default occurs, the security trustee should be required to invite the mezzanine financiers' representative to attend any meeting held between the senior lenders and the security trustee which is scheduled to involve:

- presentation by experts or the borrower; or
- decisions as to the enforcement strategy for the security; or
- decisions as to the method of realisation or disposal of any secured property.

The mezzanine financiers' representative should be entitled to present the mezzanine financiers' point of view at any such meeting but not to vote or otherwise affect any resolution of that meeting.

Mezzanine financiers should have a right to be kept informed concerning any enforcement action taken under the securities on behalf of the senior lenders. The security trustee should be required to give the mezzanine financiers a copy of any written notice given to the senior lenders by the security trustee or given to the security trustee by the senior lenders, in either case, under the security trust deed concerning any actual enforcement against any security provider or under any security or concerning events of default, waivers, consents or lock ups as and when that notice is given to or by the senior lenders as the case may be.

During the enforcement restriction period, generally speaking the mezzanine financiers will not have any right to apply for the winding up or other insolvency, administration or other action available at law for debt recovery in respect of the borrower without the consent of the senior lenders except if:

- the borrower has funds available to pay the mezzanine financiers; and
- such payment would be permitted to be made under the terms of the cash cascade; and
- the borrower fails to make such payment after notice to the borrower and senior lenders.

Winding up of borrower

Mezzanine financiers:

- should be permitted to accelerate and prove in any winding up or liquidation of the borrower; and
- except where a payment failure has occurred (in which case the mezzanine financiers may vote as they see fit except on matters that materially prejudice the interests of the senior lenders), should be required to vote in accordance with the instructions of the senior lenders.

Any money received or recovered will be required to be applied in accordance with the agreed order of ranking of debt.

Duties of security trustee to mezzanine financiers

In determining what, if any, enforcement action might be taken, the security trustee and the senior lenders will be entitled to treat the interests of senior lenders as paramount in all respects. However, in enforcing the securities or exercising any power under a senior debt document, the security trustee and senior lenders should be required to have due regard for the interests of the mezzanine financiers where not inconsistent with the interests of the senior lenders.

In addition, the security trustee should undertake that it will not without the prior written consent of the mezzanine financiers:

(a) amend or vary any security interest or guarantee if it would cause any mezzanine financier to cease to be a beneficiary under the security trust deed or to be unsecured in respect of all or any part of its exposure; or

(b) amend or vary any provision of the security trust deed that materially prejudices the rights of the mezzanine financiers or increases the obligations of the mezzanine financiers or causes any mezzanine financier to cease to be a beneficiary under the security trust deed or to be unsecured in respect of all or any part of its exposure.

(c) release any assets from a security interest (except for disposals which are permitted by the finance Documents or on enforcement of the relevant security in a manner consistent with the intercreditor principles).

Right to acquire senior debt

One way for mezzanine financiers to regain control is to replace the senior lenders - to do so they will need to acquire the senior debt. Therefore, the borrower and the senior lenders should be required to grant to the mezzanine financiers the right to compulsorily acquire all outstanding senior debt at any time at the par value of the senior debt at the time of acquisition (ie, the value of principal and accrued interest on the senior debt at that time including the reduction in principal from its original levels by mandatory repayments, mandatory prepayments and voluntary repayments).

Senior lenders will usually only permit mezzanine financiers' rights in this regard to arise in circumstances where the mezzanine financiers have been in payment lock up for a period of greater than say 12 months.

Restrictions on refinancing of senior debt

Borrowers and senior lenders will usually insist upon the borrower having a right to refinance the senior debt at any time. For senior lenders, refinancing is a necessary exit strategy which they will not agree to close off.

However, mezzanine financiers are entitled to protection when this occurs. Accordingly, the borrower should only be permitted to refinance the senior debt if:

(a) it is on terms consistent with the security trust deed;

(b) the proceeds are used to refinance existing senior debt;

(c) the refinancing of the senior debt does not exceed an amount equal to the principal amount of the equivalent senior debt then outstanding plus all unpaid interest accrued to the date of payment of the senior debt. Similar concepts should apply to the refinancing of any working capital facility (ie, should not exceed the maximum committed amount of the working capital facility) and new derivative transactions should only be permitted within existing hedging policy or if notional principal amount of all hedges does not exceed the amount of the refinancing debt;

(d) the financiers providing the refinancing senior debt are not granted any security interest by a security provider in addition to the security, unless otherwise agreed by the security trustee (acting pursuant to the instructions of all security beneficiaries including the mezzanine financiers);

(e) the lock-up and default regimes are no more onerous than the existing regime and will not prejudice any scheduled payments due under the mezzanine financing documents, by reference to the then agreed bank base case model (which must be agreed by the mezzanine financiers);

(f) the amortisation profile is not more onerous than the existing regime over the term to maturity of the mezzanine debt;

(g) the other terms of the refinancing do not vary from the existing senior debt in a way which prejudices the mezzanine financiers unless they have consented to such variations; and

(h) there is no diminution or reduction in the level of security for the mezzanine financiers.

In order to protect the position of mezzanine financiers, the maturity date of the refinanced senior debt should be no later than the maturity date of the mezzanine debt. However, if the term of the refinanced senior facility is to extend beyond the maturity date of the mezzanine debt, then the mezzanine financiers should insist that they rank pari passu with the senior lenders and the enforcement restriction period should cease.

Payment to mezzanine financiers

Payments of interest, fees and principal owing to the mezzanine financiers should be permitted provided:

(a) all scheduled senior debt principal, interest and fee payments which are due and payable (including hedging payments) have been made;

(b) the available cash is not subject to any lock up in relation to senior debt; and

(c) no "payment blockage" is in effect.

A payment blockage will usually arise if an event of default or potential event of default subsists in relation to senior debt. However, a payment blockage should only be permitted to last for a limited period (eg, up to 180 days) and the senior lenders should be prevented from initiating another blockage in relation to the same circumstances until a specified period (say 12 months) after the date of the event which gave rise to that original blockage. Without this protection, mezzanine debt could be in perpetual lock up.

The mezzanine debt will usually mature no earlier than six months following the expiry date of the senior debt but the terms of the mezzanine financing documents should permit the borrower to repay the mezzanine debt by payment of all amounts outstanding in relation to them at any time, provided the repayment is permitted as set out above or refinancing subordinated or mezzanine debt is available for this purpose.

Security Required By Project Financiers

Wherever possible, financiers will seek to have security over all of the assets of a project which will, if the borrower defaults, entitle the financier to take possession of the project and its cash flows and, if necessary, to sell the project as a going concern. In many cases, this will not be the only reasons for taking security, particularly if the project assets are of a kind which are difficult for a financier to manage or dispose of; for example, a plant for the treatment of hazardous waste. In fact, in many cases, financiers recognise that if the

borrower cannot make the project work then it is unlikely that a receiver appointed by the financier will be able to do better. Nevertheless, project security will be taken for defensive reasons such as to obtain a ranking before unsecured creditors, and to prevent unsecured creditors dominating the borrower.

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

If the borrower company has any non-project assets, it is desirable for project securities to extend to all of the assets of the borrower, so as to avoid the appointment of an administrator to the borrower interfering with the financier's powers of enforcement. Under the Corporations Act, a secured creditor may not, in general, enforce its security after the appointment of an administrator, unless the secured creditor has a charge over "all or substantially all" of the chargor's assets[39] and acts within ten days of the appointment.

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

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

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

If the assignment involves sales proceeds or other book debts, there is still a debate over the ability of a financier to have a fixed charge or assignment by security over those book debts in circumstances where the borrower is free to deal with the proceeds of the book debts. The conventional view, until recently at least, is that there must be "some real and not illusory, consent and control provisions and defined procedures which regulate the use of sale proceeds by the borrower".[40]

In a project financing it is not uncommon to find such controls, particularly if the structure already involves the borrower establishing control accounts with the facility agent or security trustee. Until the decision of the Privy Council in *Re Brumark* (*Agnew v The Commissioner of*

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[39] Corporations Act, s. 436C.
[40] A. Millhouse, "Project Financing", *Banking Law Association Conference Papers* (1992), p362.

Inland Revenue,[41] there was an emerging strand of authority, based on some decisions of single judges, that such an elaborate procedure was not necessary and that it is possible to have a fixed charge over sales proceeds and other book debts so long as the security floats over their proceeds.[42] However, in *Re Brumark*, the Privy Council decided that it was not possible to draw a distinction between a book debt and its proceeds and that in order to have a fixed charge, the financier needs to exercise real control over the relevant book debt.

This issue was recently considered again by the English Court of Appeal in *National Westminster Bank plc v Spectrum Plus Ltd*[43] where the Court held that a charge on book debts that prohibited the customer from disposing of the book debts (prior to collection) and required that the proceeds be paid into an account with the chargee bank, was a fixed charge. The Court found the charge was fixed for two reasons:

- first, the Court found that it was bound to follow the Court of Appeal's earlier decision in *Re New Bullas* in which the Court held that it is possible to have a fixed charge over book debts even though the chargor is entitled to collect and use the proceeds of those debts, the proceeds being subject to a floating charge. The Court held that it was not bound by the Privy Council decision in *Brumark* in which Lord Millett overruled *Re New Bullas* and cast doubt on whether a *Siebe Gorman* style debenture created a fixed charge over book debts.

- second, the court thought is was critical that Spectrum was required to pay the proceeds upon collection of its book debts into its account with NatWest. The requirement to pay the proceeds of its book debts into its account with NatWest (and not to dispose of them) coupled with NatWests' ability to dishonour any cheques drawn against that account gave NatWest a fixed charge over the book debts. The Court was also influenced by the fact that banks had used *Siebe Gorman* type of debentures for over 25 years on the understanding that they created a fixed charge and this would have led the Court to find that such a charge had, by customary usage, acquired that effect.

Neither *Re Brumark* nor *Spectrum* is binding in Australia, but they are persuasive. In relation to project finance transactions, one commentator has noted that:

> *"it is clear that what the parties intend to create is a fixed charge and it is hoped that the courts will respect this. However, there is no guarantee that such measures (short of the extreme measure of the chargee having to physically approve each transaction) will escape recharacterisation by the courts. This uncertainty is regrettable."*[44]

The decision in *Spectrum* is at least helpful as it supports such arrangements being effective to create fixed charges. But even in *Spectrum*, Lord Phillips highlighted the desirability of legislation in the United Kingdom so that priorities upon insolvency do not "turn upon the technical skill with which the bank accounting arrangements have been set up" - this technical skill relating to such matters as the control over payments in and out of the account held with the chargee bank.

External collateral

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[41] [2001] 2 AC 710. Since affirmed by the House of Lords in *Re Cosslett* (reported as *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2001] 3 WLR 1347.

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

[43] [2004] EWCA Civ 670.

[44] Yuen-Yee Cho, "The Fixed and Floating Charge", Australian Finance Law (Thomson, Lawbook Co), 5th Edition, at Chapter 18, p472.

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

Equity injection

In most project financings, the project sponsor is required to contribute equity to the project. Project sponsors often prefer to defer the injection of their equity to completion of the project. For example, in the case of large construction companies which will often prefer to inject equity at the latest possible time so as to minimise the time in which sponsor cash is locked up in the project. Other sponsors, on the other hand, (particularly financial and constitutional investors) may prefer, however, to inject equity at financial close in the form of subordinated debt and receive (or accrue) a debt return on that "equity" until completion.

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

Performance guarantees

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

In this context, it is worth making some observations about the practice of requiring bank guarantees or performance bonds from construction contractors. These issues were recently considered by the Victorian Court of Appeal in *Anaconda Operations Pty Limited v Fluor Daniel Pty Ltd.*[45] The case was an attempt by the contractor under a building and engineering contract to prevent the enforcement of a bond or the application of its proceeds by the owner. The bonds in question represented 5% of the contract price under a design and construction contract entered into by Fluor Daniel Pty Ltd of a nickel and cobalt extraction plant at Murrin Murrin in Western Australia.

The Court of Appeal confirmed the well understood position that a court would only interfere with payment under such bonds in very limited circumstances noting, however, that the contract itself could regulate when such bonds could be called on. Brooking JA commented:

> *"Now it is of course, plain that while, in the absence of fraud known to a bank and possibly some other very special circumstances, a bank which has given a bond in terms like the present ones must pay on demand and is not concerned with the underlying contract between contractor and owner, yet the terms of that contract may be such as to make it wrongful, as between the parties to it, for the owner to make a demand on the bank, and that if this is so, the contractor may seek an injunction to prevent the owner from making the demand. The efficacy of such a contractual*

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[45] 1999 VSCA 214. Unreported judgment.

> *restriction is undoubted: Bachmann Pty Ltd v BHP Power New Zealand Ltd [1991] VR 420 at 429-30 and cases there cited."*[46]

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

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

The case highlights the need for project vehicles and sponsors to carefully consider the wording of those provisions of the design and construction contract dealing with performance bonds or retention money and the application of such money. In this regard, Brooking JA noted that the provisions of the contract in the Anaconda case were "unusually simple and , I think, unusually clear" so one could do worse than to use these as a guide.[47]

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

Letters of comfort

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

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

Direct payment obligations

Where a financier relies upon third party credit support which is intended to create an independent or autonomous liability of the issuer, such as a letter of credit or a performance bond, the letter of credit or performance bond will not in all circumstances protect against the insolvency of the borrower. For example, if the borrower performs the obligation the subject

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[46] Ibid at paragraph 8.
[47] Ibid at paragraph 2.

of the letter of credit or performance bond while insolvent, the letter of credit or performance bond will expire (because the borrower's obligation has been performed), but a liquidator may require that the benefit received by the borrower be disgorged on the basis of preference under s.588FA of the *Corporations Act*. It is not to the point that the letter of credit or performance bond could have been called upon had the beneficiary chosen to do so.

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

In light of the full Federal Court decision in *Re Emanuel (No 14)*,[48] some commentators have suggested that even a payment under a direct pay letter of credit or performance bond could be vulnerable to attack as a preference. In *Re Emanuel (No 14)*, the court focused on the fact that it is the overall transaction which extinguishes the debt in question that constitutes a preference under s.588FA, not the particular payment which extinguishes that debt. In that case, the court held that a transaction is the totality of dealings initiated by the debtor so as to achieve an intended purpose of extinguishing a debt. As a consequence of this decision, it has been suggested that payment by the issuer of a letter of credit or performance bond could be aggregated with the reimbursement of the issuer by the borrower. Whether the issue is as serious as some commentators apprehend is open to some doubt if the view is taken that any such aggregation of dealings takes into account any security given to the issuer by the borrower over its assets as part of the overall transaction.

In any event, since *Re Emanuel (No 14)*, *Thompson Land Ltd v Lend Lease Shopping Centre Development Pty Ltd*[49] has given some comfort (although based on a predecessor provision to s. 588FA). In that case, McDonald J. in the Victorian Supreme Court focused on the autonomous nature of the issuer's obligation to the beneficiary. In that case, the issue was whether certain payments made by ANZ by way of bank cheque were dispositions of the insolvent company's property. ANZ argued that each bank cheque was a payment made by ANZ pursuant to its unconditional obligation to Lend Lease as principal under a bank guarantee issued by ANZ and were paid by ANZ out of its funds.

McDonald J. noted that irrevocable letters of credit, purchase bonds and bank guarantees were of considerable significance in every day commercial transactions and noted that injunctions to prevent payment under such instruments were very limited. His Honour noted that in taking the bank guarantee, Lend Lease was entitled to rely on the financial strength and integrity of ANZ. It needed to have no concern or regard to the capacity or ability of Thompson Land to honour its contractual obligations with respect to these matters. Lend

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[48] *Re Emanuel (No 14) Pty Ltd (in liq.); Macks v Blacklaw & Shadforth Pty Ltd* (1997) 147 ALR 281. A similar issue may come before the Courts again in *New Cap Reinsurance Corp Ltd (in liq) v Somerset Marine Inc.* In interlocutory proceedings in that case in 2003, the NSW Supreme Court noted that a request by a third party to establish letter of credit as security for losses under reinsurance contracts, the insolvent company's request to its bank to establish letters of credit, establishment of those letters of credit, a call by the third party on the letters of credit, payments of them by the issuing bank and the issuing bank reimbursing itself out of security lodged by the insolvent company as collateral could be regarded as a transaction for the purposes of s588FA of the Corporations Act.

[49] [2000] VSC 108.

Lease was entitled to look to ANZ on each of the four occasions for payment from its funds and resources of the moneys comprising the four bank cheques which were in aggregate an amount that ANZ had guaranteed to pay to it pursuant to the bank guarantee.[50] His Honour found that the payment by bank cheque in that case by ANZ was from ANZ's own money not that of the borrower.

Although the issue is not as clear cut as might be liked, commentators now seem to accept that a payment by a bank, of an autonomous obligation (eg, under a bank guarantee, performance bond or letter of credit), is likely to be regarded as independent of the insolvent company's indebtedness.[51] However, as a precaution, it is prudent when acting for a financier which is relying on an instrument such as a letter of credit or performance bond to include, on the face of the instrument, a statement that the issuing bank will pay any claim out of its own funds.

In "greenfield" projects, it is often a requirement that sponsors provide direct pay letters of credit to support their obligation to contribute equity to the project. So, for example, it may be more tax effective for the sponsors to arrange a finance facility to find their equity contribution (often referred to as an equity bridge facility) during the construction period. Sponsor equity will then be contributed upon completion occurring (or earlier if default occurs). This obligation will be supported by direct pay letters of credit. Financiers often require that such letters of credit be issued by OECD banks which have a minimum long term credit rating of a specified level (eg, AA- or its equivalent) from a recognised ratings agency.

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

ISDA Master Agreement and flawed asset provisions

Late in 2003, an Australian court upheld the operation of the flawed-asset provision in standard derivatives documentation, reinforcing the right to freeze outstanding payments on derivatives if a counterparty is insolvent.

The decision of the Supreme Court of New South Wales in *Enron Australia v TXU Electricity*[52] concerned electricity swap transactions between Enron Australia and TXU Electricity that were governed by an International Swaps and Derivatives Association (ISDA) Master Agreement. When Enron Australia was placed into voluntary administration on December 3 2001 there were 78 such transactions outstanding. Some of these had a scheduled maturity as late as December 31 2005. The company's creditors placed it into liquidation on January 29 2002. The administration and the liquidation each constituted an event of default in respect of Enron Australia under the ISDA Master Agreement.

The terms of the transactions and the state of the market were such that if the transactions were then closed out, TXU would have been obliged to make a net payment to Enron Australia. However, TXU did not exercise its right to close out the transactions. It chose to

[50] Ibid
[51] See L. Aitken, "The Paying Bank and the Preference" (2001) 12(1) JBFLP 51 at p53-55 and P. Cornwell, "Project Finance", in *18th Banking Law Conference* p11-14.
[52] 48 ACSR 266

make no further payments, relying on the flawed-asset provision of the ISDA Master Agreement.

Enron Australia's liquidator sought to have the net value of the outstanding transactions paid to it by seeking leave from the Court to disclaim the contracts and also a court order that TXU be required to determine the close-out amount and that this amount become payable.

These were sought under the provisions of the Corporations Act 2001 (Cth) that relate to disclaimer of contracts by a liquidator, under which the powers of the Court are broadly defined.[53]

But the Supreme Court of New South Wales found it did not have the power to vary the contracts in such a manner. According to Austin J, the relevant provisions of the Corporations Act did not "permit the Court to deprive the counterparty of its contractual rights, such as the right not to designate an early termination date under section 6(a) after an event of default occurs and the right under section 2(a)(iii) not to make a payment under section 2(a)(i) while an event of default continues".

Austin J made several findings under the relevant provisions of the Corporations Act as follows:

- the Court was not permitted to bestow on the company in liquidation substantive rights that it did not have under the contract to be disclaimed;
- the counterparty's existing vested contractual rights and benefits are, generally speaking, unaffected by disclaimer;
- the Court was authorised to make orders "in connection with" anything that arises under or relates to the contracts in their current form, not matters that would only arise under, or relate to the terms of, the existing contract if those terms were altered. The order Enron Australia was seeking would require that an agreed term of the contract (that TXU is not obliged to close-out the transactions) be negated and, as a result, this was not authorised;
- although the general legislative intent of the disclaimer provisions is to facilitate the efficient administration and distribution of the insolvent estate, there is no intent to include the right to vary the contractual rights and liabilities of other parties existing before the disclaimer, even where such a variation might contribute to the liquidator's efficient administration.

The decision is important in at least two contexts:

- the implications it has for the ISDA Master Agreement specifically; and
- the implications it has for flawed-asset provisions generally.

Implications for ISDA Master Agreement

The case highlights the effect of section 2(a)(iii) of the ISDA Master Agreement. Under the 1992 ISDA Master Agreement, there is no contractual limit on the time that a non-defaulting party can suspend the performance of its obligations while an event of default is continuing. Also, no interest accrues against the non-defaulting party during such a suspension. However, the defaulting party's obligations are not suspended and interest accumulates during their non-performance.

The Court's recognition of the effectiveness of section 2(a)(iii) in this context means a party whose counterparty defaults can indefinitely defer its performance of the transaction, avoid

[53] See Division 7A (ss568 - 568F).

interest accruing against it, escape closing out the transactions while they are out of the money and charge interest to the defaulting party. This is a powerful collection of contractual rights. In the project finance context, these rights could deprive an insolvent project company of a valuable asset namely the close out amount due to it from the non-defaulting counterparty under a hedge agreement. To avoid this result, it may be necessary to override the operation of this section and require the counterparty to pay the close out amount and then share in the proceeds of enforcement with other lenders.

The relevant provisions under the 2002 ISDA Master Agreement are the same as those in the 1992 ISDA Master Agreement, with the exception that effectively interest does accrue against the non-defaulting party and is payable when the suspension on performance is lifted.

TXU and Enron Australia had included an additional termination right in their ISDA schedule. This allowed TXU to designate an early termination date if it satisfied all its present and future payment or delivery obligations (whether absolute or contingent) under outstanding transactions. This is a reasonably common provision in Australia and is similar in effect to the provision used internationally, which qualifies section 2(a)(iii) in the same circumstances.

Enron Australia's liquidator claimed this provision gave it the right to terminate the outstanding transactions following the expiry of the final transaction. But the Court needed to make no decision on this point.

However, it is unclear how Enron Australia would have had such a right without paying all amounts it owed under the expired transactions. Even on paying those amounts, section 2(a)(iii) would continue to be effective so that TXU would still have no obligation to make its payments under the transactions. Also, Enron Australia would be in the extraordinary position of closing out a transaction where the only amounts included in the close-out calculation are the amounts unpaid by TXU that have never been due and payable (section 2(a)(iii) is ignored for the purpose of calculating close-out amounts).

Another important consequence of the Court's decision relates to the effectiveness of close out netting. One key concern in netting is to prevent the liquidator cherry picking favourable transactions. Its power of disclaimer is the primary means by which it may attempt this. Part of the defence is that section 2(a)(iii) means there is nothing for the liquidator to cherry-pick. No amounts are payable to the defaulting party while the default subsists.

The Court's decision on the effectiveness of section 2(a)(iii) in the face of a purported disclaimer reinforces the ability to fend off a liquidator trying to cherry pick. Of course, in some jurisdictions such as Australia, this issue is negated if close out netting takes place in a manner protected by the operation of netting legislation.

Implications for flawed asset provisions

The *Enron Australia v TXU Electricity* decision has application beyond derivative master agreements. It represents one of the few cases that consider the enforceability of flawed-asset provisions on insolvency.

The most common use of flawed-asset provisions is in the terms of deposits made by a borrower with a financier. In these circumstances, the provisions usually provide that the deposit is not repayable unless amounts owing to the financier or some other person are paid first.

A liquidator's power to disclaim contracts is one of the tools it might use to attempt to unwind a flawed asset. It is noted in the decision that Enron Australia's liquidator sought the order requiring the payment of the close out amount because of the liquidator's concern that if it simply disclaimed the contract with TXU then it would forgo the benefit of the outstanding transactions.

While there was not direct comment on this, the Court stated that a disclaimer by a company's liquidator deprives the company of its right to future performance of the contract

by the counterparty. As a result, if a liquidator wants to defeat a flawed asset provision, it will need to obtain an order from the Court to rewrite the relevant contract so as to release the flaw.

Enron Australia v TXU Electricity clarifies that the Court does not have this power in Australia. This line of attack against flawed-asset provisions is unavailable.

Consent Deeds

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

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

A consent deed will normally contain:

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

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

(c) ***cure rights and extended periods*** - an obligation on the contract counterparty to ensure that the financier has sufficient notice to enable it to remedy any breach by the project vehicle. In some cases, the financier will insist on extended cure periods over and above the cure period available under the contract to the project vehicle itself;

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

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

Consent deeds can give rise to a number of issues of concern to the contract counterparty and can lead to difficult negotiations between contract counterparties and financiers. For example, it is sometimes frustrating for a third-party long-term supplier of gas to a power project to be asked to forgo (at least to some extent) rights of termination that the supplier considers perfectly normal and which, paradoxically, the supplier would be able to obtain from purchasers with a far better credit standing than a sole purpose project company.[54]

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

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

Appointment Of Receiver and Manager

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

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

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

Performance Of Contract By Financiers or Receivers and Managers

One issue which is of concern to contract counterparties is whether, if a receiver and manager is appointed by the financier to take possession of the property the subject of the relevant project contract, the financier and its receiver and manager should be required to agree to perform all future obligations under the relevant project contract from the date it takes possession?

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

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

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

(a) receivers who enter into possession of a company's premises as its agent do not thereby become liable for arrears of rent before their appointment.[55] Under the general law, receivers are not even liable for rent for the whole period after possession until the date on which possession is surrendered to the company's landlord, provided they have not accepted personal liability for the rent. If, as agents of the company, the receivers and managers pay the landlord or lessor rent, they do not thereby make themselves a tenant by estoppel and incur a personal liability for the rent;[56]

(b) if receivers and managers adopt the existing lease or assume a personal liability as a guarantor of the company's obligations under the lease, they will become liable;[57]

(c) however, receivers may become personally liable under s.419A of the Corporations Act. Under s.419A, receivers and managers may give the owner or lessor of property a notice, within 7 days after the control day (as defined in s.9 of the Corporations Act), specifying certain property of the owner or lessor which the corporation is using or occupying and stating that the receivers do not propose to exercise rights as receivers and managers in relation to that property. Whilst such a notice is in force,

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55 *Rangatira Pty Ltd v Viola Hallam Ltd* [19570] NZLR 1188 at 1190
56 *Rangatira Pty Ltd v Viola Hallam Ltd* [1957] NZLR 1188, *Re British Investments and Development Co Pty Ltd* (1979) CLC 40-522. See now Corporations Act 22180-181.
57 *Titoki Farms Ltd v Lei Jay Catering Ltd* (1987) 3 NZCLC 100,009.

the receivers are not liable for the rent or other amounts payable by the corporation under a lease or hiring agreement with the owner or lessor of the property. The notice ceases to have effect if revoked by notice in writing given by the receivers and managers to the owner or lessor or if the receivers and mangers exercise, or purport to exercise a right in relation to the property as receivers and managers.

If no notice is given under s.419A(3), receivers and managers have a period of grace of seven days from the control day (as defined in Corporations Act, s.9) - during this period, they are not liable for rent or other amounts payable by the corporation under a pre-receivership lease or hiring agreement. After expiry of this grace period, receivers and managers will be personally liable for such amounts as long as they continue as receivers and managers and as long as the corporation continues to use or occupy, or to be in possession of, the property of the owner or lessor.[58] This prescribes the extent of their liability under the pre-receivership lease or hiring agreement, and they are not taken to have adopted the lease or agreement simply because they are liable for the rent or other amounts after the grace period expires.

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

(a) under general law, receivers and managers are not personally liable upon any contracts they enter within the scope of their agency during the course of the receivership.[59] Their principal (either the company itself or the charge holder) will be liable on such contracts;[60]

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

(c) even whilst the receivers and managers' agency exists, they can assume personal liability for a contract (eg, by failing to disclose their agency);[61]

(d) receivers and managers are under no obligation to perform trading and commercial contracts entered into by the company prior to their appointment unless a failure to do so would damage the company's goodwill.[62] Provided the company's business reputation is not at stake, receivers and managers may repudiate contracts with virtual impunity.[63] However, a receiver and manager who decides to disregard or

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

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

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

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

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

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

ignore a pre-receivership contract must act in good faith and must not act dishonestly or recklessly damage the company's equity of redemption;[64]

(e) if the company in receivership is dependent on the other party to the contract for essential supplies, the receiver's legal right to disregard or ignore the pre-receivership contract will count for little. A creditor may stipulate that no further supplies will be delivered to the company unless its pre-receivership debt is paid in full - this does not amount to economic duress or an abuse of market power although the creditor may be liable to disgorge the payment as an unfair preference in the company's liquidation;[65]

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

(f) doubts remain as to the liability of receivers and mangers in tort. It may be that where receivers and managers deliberately cause a company to repudiate a contract with a third party, they will be liable in tort.[66] However, the better view appears to be that receivers could assert that they had a legal justification for the inducement and that persons cannot be liable for the tort of interference with contractual relations if they act as agents of one of the contracting parties. On this basis, only where receivers have not acted bona fide or where they have acted outside the scope of their authority could they be held liable for procuring a breach of contract by the company;[67] and

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

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

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

- well defined defaults (ie, such as a failure to pay money), contract counterparties will often accept a further short cure period to enable financiers sufficient time to consider the default and make the payment; or

- other defaults (such as a failure to perform a non-monetary obligation), this can be more problematic. Financiers often seek lengthy additional cure periods and may

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

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

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

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

even sometimes seek an open ended remedy period as long as they have put forward a cure plan and are "diligently" pursuing a cure. Open-ended cure periods are likely to be unacceptable to most contract counterparties as vagueness and uncertainty should be avoided in termination related clauses.

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

Specific Performance Of Counterparty's Obligations Under Consent Deed

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

MI Design Pty Ltd v Dunecar Pty Ltd[68] offers comfort to financiers because the judge in that case, Santow J., showed a willingness to award specific performance of a mere contractual obligation notwithstanding some difficulties. The relevant facts were that a lessor of a hotel retook possession of a lease where the lessee had defaulted under the lease without first providing the financier with notice of the default and the opportunity to cure the default, as required by a deed of consent. Santow J. made an order for specific performance of the lessor's obligations, even though it meant reinstating an insolvent lessee. In making this order Santow J observed that if the financier was not given the chance to rectify the breach it would be at risk of losing the whole benefit of its security and that in these circumstances damages would not be an adequate remedy.[69]

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

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

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68 [2000] NSWSC 996

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

Direct Performance Undertaking In Favour Of Financiers

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

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

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

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

- if the underlying contract contains a limitation on the amount of loss which can be recovered for a breach of contract (such as a provision which precludes a party recovering indirect or consequential loss) such a provision should also be included in the consent deed; and

- loss which is peculiar to the financiers and not otherwise recoverable by the financiers against the project vehicle should be excluded.

Subordination

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

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

Subcontracts

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

Equity Party Consent Deeds

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

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

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

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

PUBLIC/PRIVATE PARTNERSHIPS

Power of government authorities

Key governmental power issues for financers in infrastructure projects are:

(a) What is the legal status of the government body which is contracting to grant the concession?

(b) Does it have express statutory power to perform its contractual obligations?

(c) Does it have statutory powers and discretions which it is not lawfully able to fetter by contract or to delegate (such that a provision of the concession deed may be read down, or ruled unenforceable)?

(d) Are the obligations of the government body obligations of the Crown or of a separate statutory body (which may have limited assets)?

Even if the contracting party is a government minister, these questions must be addressed. A minister may have express statutory power to enter into a transaction; if not, there is a need to examine whether the minister is validly exercising an implicit power within the scope of that ministerial portfolio.

The legislation establishing statutory bodies often pre-dates the private infrastructure market and does not easily accommodate the private sector provision of services.

Limitations on the government's power to contract

A number of difficult issues can arise, at common law, in relation to contracting with government. The Crown has the same power as an individual to enter into contracts, subject to the following limitations:

(a) the Crown's prerogative power can only be exercised in the ordinary course of administering a recognised part of the government of the State;

(b) where legislation deals with the same subject matter as the prerogative, the legislation will exclude the prerogative;

(c) the power to contract may be specifically or necessarily restricted by statute;

(d) the prerogative is subject to limitations arising from the nature of the Crown and its powers; and

(e) the person entering into a contract as agent for the Crown must have authority to do so; ministers of the Crown generally have authority to enter into contracts within the purposes of their portfolio. In some cases care must be taken to distinguish correctly between the contracting entity and the person who has the authority to bind the Crown[70].

Enforcement of contracts against government will also be subject to legislation such as the *Crown Proceedings Act* 1988 (NSW). Such legislation allows civil proceedings to be bought against the Crown (and bodies representing it) and authorises the Treasurer to meet any judgment. It does not allow any Court to issue execution, attachment or similar process against the Crown.

Public Authorities (Financial Arrangements) Act - New South Wales

In New South Wales, the *Public Authorities (Financial Arrangements) Act* 1987 (NSW)("**PAFA Act**") addresses the issues of contracting with the public sector, outlined above, and provides a statutory basis for the participation of the private sector in public infrastructure.

Part 2C of the PAFA Act provides for three different types of guarantee:

- under section 22A the Government guarantees the repayment by authorities of financial accommodation obtained by the issue of debenture, bonds, inscribed stock, etc;

- under section 22AA of the PAFA Act, the Treasurer may declare, by instrument in writing, that the performance of all or any specified obligations incurred by an authority as a result of or in connection with its entering into, or participating in, any specified arrangement or transaction as authorised by the PAFA Act is guaranteed by the Government. The section goes on to provide that, subject to any terms and conditions on which the declaration is made, the guarantee will be effective even if an authority ceases to exist, ceases to be responsible for the exercise of the function constituting the obligation or ceases to be responsible for the exercise of the function relevant to the performance of the obligation; and

- under section 22B the Government may guarantee the performance by an authority of its obligation in connection with a transaction authorised by the PAFA Act. The form of the guarantee is to be determined by the Treasurer.

Statutory powers and protections

A related question arises if a government body has a statutory power or protection, which is necessary to provide a service, but which cannot readily be passed on to a private sector party. For example, the water board has a statutory power to enter private land to lay, repair, and remove pipes, and read meters. There may be a statutory protection against actions by third parties. A private sector supplier wishing to install water pipes to enable itself to supply water does not automatically have these statutory rights and protections. Does it have to negotiate separately with each landowner, or can it somehow obtain the benefit of the

[70] See for example, *Town Investments Ltd v Department of Environment* [1978] AC 359.

statutory provisions, for example by a statutory delegation?

There is no generic answer to questions such as these. The answer must be sought in the empowering legislation, and in the power of the minister or a government authority to delegate its functions.

Issues for project financiers in Public/Private Partnerships ("PPP")

Each of the Australian states and the Commonwealth Government has established, or is considering establishing, co-ordinated policies for the undertaking of government infrastructure projects in partnership with the private sector (similar to the Private Finance Initiative, which has been operating for some years in the United Kingdom)[71]. Most States have now issued their policies and guidelines for PPPs which include statements of the government's position in relation to risk allocation and contractual issues[72]. In terms of implementation, Victoria is probably the most advanced having now undertaken several PPPs. The Commonwealth Government is also now considering PPP projects, for example with a number of defence contracting projects currently being considered.

Generally, government sponsored infrastructure projects under the "PPP" banner involve the private sector in:

- investing in public infrastructure projects, which may include schools, hospitals, prisons, as well as motorways, ports, and rail facilities;
- constructing the infrastructure; and
- providing non-core services. That is, court services, teaching or medical services (which are core services) would remain the responsibility of government.

PPP projects raise many of the same issues which project financiers would consider in other contexts. So project financiers will necessarily require the same package of measures which are well defined from other infrastructure contexts (such as tollroads). These include:

- ensuring that risks allocated to the project company under the project concession deed are fully passed through, in the case of construction risk, to the D&C Contractor and, in the case of operating risk, to the Services Subcontractor;
- requiring performance bonds from the D&C Contractor for an agreed percentage of the construction contract price (e.g. 10% reducing to 5% after completion) and the Services Subcontractor for an agreed number of months of service payments;
- requiring parent guarantees in respect of the performance of the D&C Contractor and Services Subcontractor;
- requiring the State, project company, D&C Contractor and Services Subcontractor to enter into consent (or tripartite) deeds with the financiers;
- restricting the rights of the project company to materially amend any project document or terminate any project document;
- requiring specified insurance cover.

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[71] See A. Millhouse, "Public Private Partnerships - the Dawn of a New Era for Project Financing?" in *19th Annual BFSLA Conference Papers* (Brisbane, 2002)

[72] In November 2001 the NSW Government released its "Working with Government policy for privately financed projects" and the "Working with Government guidelines for privately financed projects". Queensland released a public private partnership policy in September 2001 and is currently finalising its detailed guidelines with respect to that policy. Tasmania released its policy in July 2000. The South Australian Government released a policy committing to public private partnerships through the Partnerships SA Program. The Western Australian Government has also completed its public private partnership principles and guidelines.

However, PPPs raise some new and unique issues for sponsors and project financiers including the following:

(a) *Multiple subcontractors* - in some PPPs, the project company will enter into the project concession deed with the State and then subcontract the provision of services to multiple subcontractors. This raises the possibility of there being overlap or gaps in the allocation of project concession deed risks amongst subcontractors. It is important to ensure that responsibilities amongst subcontractors are clearly delineated and that there is neither overlap nor gaps - service tasks and responsibilities must be clearly allocated amongst service subcontractors so that abatement suffered by the project company as a result of service failures can be clearly attributed to the relevant subcontractor.

This also applies to the situation where services subcontractors have input into the design process - liabilities for defects must also be able to attributed to relevant subcontractors.

There needs to be a regime to deal with the situation where one subcontractor defaults - in particular, it needs to be made clear who will step in and cure the default and what happens if this failure impacts the ability of other subcontractors to perform.

(b) *Interface issues* - where there are multiple subcontractors, thought needs to be given as to how interface between the various subcontractors will be facilitated and managed by the project company. For example, in the context of a court project, there will need to be interface between the facilities management provider, the custodial services provider and the technical court services provider - interface arrangements need to be documented and a mechanism established for this to be monitored in practice. Such interface issues may also arise between the D&C Contractor and the services subcontractors in respect of input into the design process and commissioning activities.

(c) *Change in law and variations* - many PPP projects contain complex regimes for dealing with change in law risk and variations. In particular, Governments often seek to share this risk with the project company and to require the project company to absorb a specified amount of loss arising from a change in law or cost arising from a variation before the Government will provide compensation. The project company will need to price this risk into its bid - however, this can be difficult where there is an open-ended number of changes in law or variations which may occur over time. Governments can also require the project company to use best endeavours to fund the capital costs of change in law or variations - the project company will need to carefully consider whether it will be able to do this in the context of its project financing arrangements and, even if it can, whether such funding will be efficient for the project company.

(d) *Termination payments* - most PPPs provide for the State to pay compensation on the termination of the concession deed. This is often expressed as a formula with a different amount payable depending on whether termination occurs pre or post completion of the asset and whether or not termination is due to default by the project company. These formulae need to be carefully reviewed to ensure that both the sponsor and the financiers understand what will be paid by the State upon termination in various scenarios. Financiers will often require that, at least in the case of termination of the concession deed post-completion of construction of the asset, the termination payment equate to the market value of the asset at the time of termination. How such compensation is to be dealt with by the project company needs to be carefully considered particularly the issue of what is to pass through to subcontractors and what is to be paid to financiers.

(e) *Payment by instalments and novation of financing arrangements* - in some more recent PPPs, Government has sought to retain the ability to pay compensation to the

project company upon termination by instalments rather than in a lump sum and also to require the financing arrangements to be novated from the project company to the State. From a Government perspective, payment by instalments is asserted to be desirable to avoid break costs upon termination (eg, loss suffered upon termination of financing arrangements including breaking of associated interest rate swaps which may be "out of the money"). It remains to be seen how the Australian project finance market will respond to these initiatives.

The concept of compensation being paid by the State in instalments after the termination of the project concession deed raises a number of issues for financiers. Depending on the circumstances leading to termination, the termination payment may be insufficient to repay financiers in full - in this case, it is unlikely that financiers would accept payment over time when it is known that there will be a shortfall in repayment of the debt. In addition, interest will continue to accrue on the debt over the time during which instalments are paid and interest rates may move further increasing swap break costs - in both cases, financiers' exposure will continue to increase which is also likely to be unacceptable. Presumably, the project company must also continue to operate during the instalment payment period but its concession has been terminated and so it may well be insolvent and be required to appoint an administrator.

Payment of termination compensation by instalments may be linked to a novation of the financing arrangements from the project company to the State. The concept here is that the concession deed is terminated and in place of the project company as borrower, financiers will have their financing arrangements novated to and assumed by the State. The value of the termination payment to the project company is then reduced by the "market value" of the novated financing arrangements and any avoided costs of terminating contract documents. Financiers may well take the view that once the concession is terminated by the State, the project is over and the financing should be repaid at that time rather than become a lending arrangement with the State. If financing arrangements are novated to the State then financiers will presumably only accept this if there is no cap on the amount to be paid by the State under those arrangements and financiers retain all of their rights.

Rather than regimes which impose these complexities and uncertainties, a simpler approach may be for the State, as an alternative to terminating the concession, to have a right to step in and take over ownership and operation of the project company - this would allow the subcontracting and financing arrangements to continue for so long as the State wished.

(f) *Abatement* - a key element of PPPs is the abatement regime - this regime is designed to ensure adequate performance on the part of the project company (and thereby reducing government risk). To this end, key performance indicators (KPIs) are agreed upon - failure to comply with these KPIs will lead to reduction in the payment to be made by Government to the project company. Negotiation of these KPIs is a critical aspect of these projects as failure to meet a KPI can result in a reduction of the amount payable to the project company by the Government. As noted above, service failures need to be passed through to the services subcontractors who must be able to absorb the financial consequences of the abatement regime. A severe abatement regime can impact the ability of the project company to meet its debt service obligations so the regime needs to sensibly balance the interest of the Government in service quality against the impact on the project company.