Chapter 4

Contractual framework

General

The complexities of project finance are such that the project parameters and interrelations need to be managed within a clear framework, which is formalized via contracts. Project finance can therefore be subject to numerous subcontracts within the overall framework of the project financing. We consider below some of these contracts.

Pre-development agreements

Prior to commencing a project, several elements need to be already in place before the project can begin. Elements such as:

- **Licences and concessions**  In many cases, implementing a project financing in its building as well as operating phases depends on obtaining the appropriate licences, permits and concessions from the government of the country in which the project is based. The government may negotiate certain clauses which give it the right to revoke the licence or concession. Lenders should therefore seek security via a variety of issues such as government approval of the financing and of the project, and enabling the lenders to take enforceable security, manage the project if necessary, and repatriate profits.

- **Concession agreements**  Concession agreements create the right and obligation to build, own and eventually transfer back to the grantor infrastructure used for the general benefit of the population. Concession agreements should therefore clearly state the rights such as terms and duration of the concession, ability to extend the concession
even if there are changes in the law, termination of the concession should not be expropriatory, and banks should be able to freely transfer the concession to a third party.

- **Shareholder agreements**  Given that interests differ, it is desirable to have a shareholder agreement in order to govern the relationship of the stockholders with respect to the project. Such agreements include management and voting; development, construction, and operating stage financing, working capital financing; amounts and dates of additional capitalization.

- **Partnership agreements**  Where a general or limited partnership form of ownership of a project is selected by the project participants, this will be governed by a partnership agreement. The agreement will prohibit anything that has a substantial adverse impact on the project, such as taking on additional debt, amending or modifying the loan agreement or important project contracts; waiving rights to security, selling the project, etc. without the approval of a specified number of the partners.

- **Joint venture agreements**  A JV agreement will govern the interrelations amongst the participants and specify issues such as the name and purpose of the JV, management and voting rights and other mechanistic aspects of the project to be defined, such as date and time of capital injections, transferability, sale, competition, etc.

### Construction agreements

The banks’ wish list for a construction contract is fairly standard and predictable, but it should include the following aspects:

- The construction contract must be turnkey. No aspect of the construction and design should ‘fall between the cracks’. So, there must be no nominated subcontractors or equipment specified by the project company (or, if there are, the contractor must take responsibility for the same).
- There should be a fixed price, incapable of being reopened, and the price should be paid in one lump sum on completion.
- Completion must occur within a fixed period.
- The force majeure events should be limited.
Liquidated damages should be payable if completion is not achieved by a fixed date and those liquidated damages should be adequate and at least cover interest payable on the loan.

There should be no (or large) limits on the contractor’s liability.

The contractor should give extensive guarantees and, if the contractor is to be released from liability for defects after a period, that period should be long and only run from the passing of a well-defined completion test.

**Contractors bonds**

Contractors bonds provide ways of incentivizing or securing the performance of contractors, subcontractors and suppliers. The types of bonds are:

- **Bid (or tender) bonds** These bonds require the bidder to pay a penalty should they be awarded the contract and decide to withdraw. This mechanism is designed to prevent fraudulent bids designed solely to deprive competitors the work.

- **Performance bonds** These effectively guarantee performance by the contractor for a certain proportion (perhaps 5% or 10%) of the contract price.

- **Advance payment guarantees** The project company may have to advance funds to enable the contractors to purchase materials and begin working on the contract. In such cases, the contractor will provide an advance payment guarantee which means that if they do not begin (or complete beginning) working on the project, that they will have to refund the advance granted.

- **Retention guarantees** The construction contract might provide for the project company to retain a specified percentage of the progress payments, in order to repair defects which may not immediately be apparent. Conversely, the contractor wishing to receive full payment may instead offer a guarantee for the equivalent amount of the retention guarantee.

- **Maintenance bonds** These are bonds to cover defects which are discovered after completion of construction. Upon materialization of the defect, the bonds will be used to rectify the defects. Similar cover can
also be obtained by extending the time frame of performance or retention bonds.

**Operating and maintenance agreements**

Sponsors try to mitigate supply risk via several mechanisms. The major provisions that lenders look for in operating and maintenance agreements are similar to those that the project company are concerned with. These include:

- **Supply-or-pay agreements**  Also known as ‘put-or-pay’, these arrangements require the supplier to either provide the requisite input or provide cash compensation to enable the project company to obtain the requisite input.

- **Sales/off-take agreements**  Projects generally try to minimize the effects of market volatility via off-take agreements. Such contracts should protect lenders from risk between the contracted price for the output and the market price. Mechanisms which can limit market risk include guaranteed capacity payments (sufficient to cover fixed and debt service costs) and guaranteed production levels.

- **Take-or-pay and take-and-pay contracts**  Take-or-pay and take-and-pay contracts can be defined as long term contracts to pay for goods over a long term at a fixed price whether or not delivery occurs. The idea is that the purchaser ensures a steady source of supplies at a fixed price and the seller obtains some relief from price and volume volatility. Typically, the amount of the payments under a take-or-pay contract should be sufficient to cover all – or a defined part – of the operating costs and financing payments. It is essential that the ‘hell or high water’ obligation upon the purchaser be ironclad and enforceable. The rights under this contract will usually be assigned to the lenders who will have a direct claim under it should the borrower experience payment shortfalls.

- **Throughput agreements**  The concept of a throughput agreement is very similar to a take-or-pay contract except it typically is used by a facility where goods transit such as a road, port, pipeline, rail track, etc. A typical example of a throughput project is the Baku Tbilisi Ceyhan pipeline project to transport oil from Azerbaijan to the Turkish
port of Ceyhan. In such a project, the parties enter a throughput agreement with the pipeline companies under which they agreed to pass sufficient oil and gas through the pipelines at agreed tariffs so that the cash earned would be sufficient to enable the pipeline companies to meet all of their financial obligations. Such arrangements can also be subject to a ‘hell or high water’ clause so that should it become impossible to pass oil or gas through a pipeline then cash payments would be made, equivalent to the amounts needed to enable the pipeline companies to meet their commitments.

**Sponsor support agreements**

In some cases, it becomes desirable to conclude sponsor support agreements. Some methods of providing sponsor support are:

- **Working capital, maintenance and cash deficiency agreements** These provide comfort similar to a completion guarantee, except that they can remain in place (maintenance) beyond the completion date.

- **Letters of comfort** Lenders typically require letters of ‘comfort’, ‘support’ or ‘understanding’ from the ultimate shareholders of the project company or other interested parties. The legal position of these ‘letters of comfort’ is often misleading since, in reality, no guarantee exists. These letters are basically exercises in window dressing since they are unenforceable in court. If the lenders are looking for more than ‘moral commitment’, this should be clearly stated and reflected in a clearly worded document vetted by lawyers. Conversely, if sponsors do not intend to provide a legal undertaking, this should also be clearly stated. Ambiguous ‘letters of comfort’ are not only misleading, they are indeed a waste of time.

**Management agreements**

In some projects, the management of the project entity is governed by a separate document in which a project manager is appointed to manage the project. The project management agreement typically imposes on the project company certain management conditions to be decided via
negotiation. Typically, this might include management, preparing budgets and forecasts, financial and technical record keeping, reporting, construction management, etc.

**Representations and warranties**

The representation and warranty section of project contracts, including the project loan agreement, serves an important role in the project due diligence process. It basically confirms, legally, that certain conditions enabling the project to commence, are in place.

- A representation is a statement by a contracting party to another contracting party about a particular fact that is correct on the date when made. A representation is made about either a past or present fact, never a future fact. Facts required to be true in the future are covenants.
- A warranty is sometimes confused with a representation, but in practice the two terms are used together, the contracting party being asked to represent and ‘warrant’ certain facts.

Generally, a breach of a warranty could be enforced as a breach of contract. Because some courts blur the distinction between representations and warranties, the lenders typically require the borrower to ‘represent and warrant’ the same facts, and to state that the untruth of any representation or warranty is an event of default under the contract. It is important to note that linking this to an event of default enables the banks to exercise leverage over the borrower without necessarily having to initiate litigation.

The two main conditions underlying the initial representations and warranties are:

- to ensure that the legal status of the company exists, as this governs the ability to enforce the contract against a presumed set of assets, and
- to ensure that the contracting party is duly authorized to enter into the transaction (*ultra vires* – subject to any corporate or partnership restriction relating to the transaction).
Some lenders decide to verify this information as an added measure of prudence.

**Project loan/credit agreements**

Loan agreements define and regulate the financing instruments and interrelations amongst the various parties participating in the project financing. Loan agreements may be supplemented with an intercreditor agreement which defines the rights that the project creditors will have in a default, including step-in and foreclosure.

Another role of loan documentation is to ensure that the initial credit risk profile remains unchanged over the life of the facility. This is achieved by implementing various conditions and covenants in the loan agreement which define what the management can and cannot do.

Loan agreements, via financial or ratio covenants, can also be used to oblige the borrower to maintain certain parameters such as liquidity, cash flow and other elements which may adversely impact the borrower’s (and project’s) risk profile.

The typical project finance loan agreement will govern several elements:

- mechanistic provisions (e.g. loan payments and repayments);
- interest rates and provisions;
- lender protection against increased costs and illegality;
- representations and warranties;
- events of default;
- miscellaneous provisions, including submission to jurisdiction.

The credit agreement moreover will address matters that reflect the transnational nature of the transactions, e.g. waiver of sovereign immunity (in the case of projects with a government component); identification of the currency for debt repayments.

The goal of the project finance lender is to address the control over as many project risks as is possible. To the extent risks (economic/political)
cannot be adequately regulated, these must be addressed in the interest rate and fee pricing of the credit.

**Credit agreements – basic terms**

Typically, terms of the credit agreement will include the following:

- **Conditions precedent** These would include the delivery of certified copies of the borrower’s constitutional documents, of any relevant board and shareholder resolutions and of any key documents and the delivery of legal opinions confirming, *inter alia*, that the loan agreement was within the borrower’s powers and had been properly authorized.

- **Conditions precedent to each drawdown** Specific conditions to satisfy prior to each drawdown of funds (e.g. obtaining a completion certificate or engineering progress report).

- **Drawdown mechanics** The specificities relating to drawdowns (approvals, account numbers, dates, prorate allocations, etc.).

- **An interest clause** Interest is charged by reference to base rate; the loan agreement should stipulate which bank’s base rate is being used.

- **A repayment clause** A term loan may be repayable in one bullet repayment or in instalments of fixed or variable amounts.

- **Margin protection clauses** If a bank suffers an unexpected cost connected with making a loan, this will obviously erode its margin: Three main types of margin protection clause are included in loan agreements as a result: the gross-up clause, the increased costs clause and the market disruption clause.

- **The illegality clause** This clause states that, if it becomes illegal for a bank to continue to make loans or otherwise participate in the loan agreement, the borrower must prepay the loans made by that bank and the bank’s obligations will be terminated.

- **Representations and warranties** If things go wrong, the banks simply want their money back and the best way to do this is to give them a debt (and not a damages) claim. This is done by making the breach of representation and warranty under the loan agreement an event of default (see below). The representations and warranties are often made ‘evergreen’, which means automatically renewable on a permanent basis.
**Undertakings**  These are things that the lender must do. A loan agreement will contain various undertakings from the borrower, ranging from the purely informative (e.g. provide annual accounts) to the financially protective (e.g. an undertaking not to create security in favour of third parties). The three key undertakings in a typical loan documentation are the **negative pledge**, an **undertaking not to dispose of assets** (unless waived) and an undertaking by the borrower **not to change its business**. The purpose of these undertakings is to force the borrower to keep the risk profile he had upon entering the transaction.

**Events of default**  Events of default in a typical loan agreement may include non payment, breach of representation and warranty, breach of covenant, insolvency and ‘cross-default’. These are financial events of default which means that the borrower has failed to maintain or respect certain financial conditions. The cross-default clause basically comes into effect when the borrower defaults on borrowings or financial obligations with a third party. Since a cross-default is often an indication of serious financial problems, the cross-default clause enables the bank which is exposed to move to foreclose on the loan even if no default has occurred.

### Significant provisions of the project finance credit agreement

The main provisions of project finance credit agreements are:

**Additional indebtedness**  Project-financed transactions, on occasion, need to issue additional debt for various purposes, such as capital improvements, cost overruns, changes in environmental or economic legislation, etc. It is important that the banks exercise control and therefore additional indebtedness should only be permitted if the banks grant their approval. Limitations on additional indebtedness therefore typically figure in a project finance loan documentation.

**Distribution of dividends**  In order to prevent funds from being siphoned out of the company, the loan documentation will typically put a limit on dividend payments. These limits will be defined in function of the borrower’s financial ratios such as available cash flow to financing payments. Here, the stronger the cash flow coverage, the higher the limit of dividends permitted. It is important however to
have an overall cap on dividends in order to ensure that project proceeds are ploughed back into the company and not siphoned off steadily, resulting in long term weakening of the borrower.

- **Grace periods prior to default**  Due to the complex multinational nature of project finance, it is possible that payment delays may arise due to the trustee having administrative difficulties. Therefore project lending documentation will also include grace periods for missed principal and interest periods. However, too much leeway may invite difficulties, this is why such grace periods should be no more than three to five days.

- **Restrictions on intercompany loans**  Project finance is, by definition, based on the use of a non-recourse vehicle providing certain off balance sheet benefits to sponsors. In order to ensure that the financial balance of such an arrangement is not upset, banks will require that there be restrictions on intercompany loans. This is to prevent the project sponsors of manipulating and weakening the project entity by making transfers to and from reserve accounts etc.

- **Reserve accounts**  Project financing documents typically require projects to maintain several accounts with the project trustee. This may include a reserve account, a debt service reserve account, or an environmental legislation reserve account. Complying with such reserve accounts ensures that the project entity is protected in the event of any future legislative or regulatory changes.

- **Insurance**  Project financings should ensure that all operating company and machinery is covered by reputable (investment-grade rated) insurance companies. It would be an added plus if the insurance company’s claims settlement procedures not extend indefinitely in an effort to improve its ‘liquidity management’.

### Covenants

Covenants are undertakings given by a borrower as part of a term loan agreement. Their purpose is to help the lender ensure that the risk attached to the loan does not unexpectedly deteriorate prior to maturity. Covenants may, for example, place restrictions on merger activity or on gearing levels. Breach of a covenant normally constitutes an event of default and, as a result, the loan may become repayable upon demand.
From the borrower’s point of view covenants often appear to be an obstacle at the time of negotiating a loan and a burdensome restriction during its term. As mentioned, they may also precipitate default. In order to negotiate an appropriate set of covenants, however, it is important for the borrower to have an understanding of the logic underlying the lender’s position.

In the first instance the lender is using covenants to protect itself against possible actions the borrower could take, especially in times of financial distress, which would damage the lender’s position. These actions are looked at in more detail below. Taking this a stage further, however, it can be expected that if the lender is unable to achieve adequate protection via covenants it will seek compensation, for example by requiring a higher margin. In some instances the covenants ideally wanted by the lender may be unduly restrictive and it may therefore be cost-effective for the borrower to be prepared to pay more for a greater degree of freedom. In other cases, however, it will be possible to negotiate an economically acceptable set of covenants in return for more favourable terms elsewhere in the contract. In instances such as these, debt covenants can be of benefit to both lender and borrower.

The games borrowers play

What specific actions by borrowers are lenders seeking to protect themselves against? These can be classified as financing, dividend or investment decisions that it is feared borrowers may take to enhance their own financial position at the expense of that of the lenders.

- **Financing decisions** The borrower could dilute the claim of the lender in question by subsequently raising additional debt having an equal or even a prior claim over the company’s assets. If the original lender did not allow for this eventuality, then the borrower will have gained at the expense of the lender’s position having become more risky.

- **Dividend decisions** A loan may be extended in the expectation that the borrower will maintain existing dividend and reinvestment policies. However, the borrower may start to pay out dividends in excess
of those envisaged by the lender at the expense of capital spending, so reducing the lender's asset backing.

- **Investment decisions** Two contrasting problems are anticipated under this heading; a failure to undertake certain potentially profitable investments and an over-eagerness to embark on excessively risky ones.

- **Under investment** Take the example of a company in financial distress, i.e. one whose outstanding loans exceed its asset value. The shareholders of such a company may be unwilling to finance a profitable project if they perceive that most of the benefit will simply accrue to the creditors by way of reducing the shortfall in asset value. In effect this is the dividend payment problem under another guise. Excessive dividends entail an unexpected cash outflow whereas here shareholders are failing to inject funds into the business.

- **Increasing business risk** Continuing with the example of a financially distressed company, it could be advantageous to the shareholders to switch into investments or business projects that are riskier than those that were held at the time the original loan was made. This is because in the likely event that such a project will fail, given its high risk, the loss will be borne in the main by the company’s creditors in the form of an even lower payout than they were going to receive in the first place. In the improbable event of a substantial profit, however, the bulk of the benefit will accrue to the shareholders because the creditors’ claims cannot exceed a fixed amount. Given the originally shaky position of the company, an increase in business risk will thus benefit the shareholders and disadvantage the creditors.

In summary then, lenders negotiating term loans will be concerned that, once the facility is in place, borrowers may unexpectedly raise additional debt finance with an equal or prior claim; pay out excessive dividends; fail to adequately maintain asset levels; or increase the risk profile of the company’s assets. These would all be ways of benefiting the borrower at the expense of the lender. Moreover they are particularly relevant in the context of financially troubled companies. This is for two reasons. First, the raising of excessive amounts of additional debt can itself hasten financial distress. Secondly, the dividend and investment policies described are most likely to benefit shareholders at the expense
of lenders when the company is already in or approaching financial difficulties.

Functions of loan covenants

In the light of the above, it would appear that loan covenants have four key functions:

- To place some restraint on the danger that a company may become financially distressed. This is achieved, for example, by gearing limits.
- To provide the banker with an early warning if, nevertheless, a company is beginning to have problems or is significantly changing the nature of its operations.
- To limit the extent to which borrowers can take actions such as those described above, which they may be particularly tempted to do when approaching financial distress.
- Finally, if necessary, to trigger loan default.

Proponents of the use of covenants, emphasizing the early warning function of covenants, take the case further by arguing that well-designed covenants provide not only timely performance indicators but also open up lines of communication between borrower and lender. Thus covenants serve to advise the borrower of what elements are of particular concern to the bank in difficult times, and when the company may need the forbearance and possibly active support of its banks, covenants ensure that the banks are well informed, supportive and less likely to impose draconian measures on management which may serve to unnecessarily accelerate panic in the markets.

Drawbacks to loan covenants

It is, nevertheless, recognized that covenants are not a universal panacea for resolving lender–borrower conflicts. For example, at some time during the term of a loan a once-relevant covenant may require amendment due to a change in circumstances. However, this may be costly to achieve, especially where a company has many bilateral agreements all requiring amendment or a syndicated facility requiring a large
majority, or even unanimity, to agree amendments. Also, contractual restrictions on management activity can turn out to be more costly than the damage they are intended to limit. This is partly because covenants are sometimes a very blunt tool for controlling certain management activities, in particular investment decisions. Furthermore, setting appropriate levels for ratio covenants is not a science. If the ratios are too loose they will fail to control for the matters discussed above. If they are too tight, they will place unnecessary restrictions on the borrower and may trigger an unwarranted default.

Guidelines for efficient covenanting

It is this recognition of both the costs and benefits of covenants that has led one writer to suggest three guidelines for efficient covenanting:

■ Covenants place limitations on borrower action. Therefore, in return, they must be seen to provide lenders with an appropriate form of economic protection. For example, to what extent does the widely used borrowings/capital and reserves ratio, based as it is on balance sheet values, actually provide the lender with either a measure of asset backing or a reliable indicator of impending financial distress?

■ Covenants should not be so extensive that the protection afforded to the lender is outweighed by the costs they impose on the borrower in terms of restrictions on management action. For example, it would be very difficult to design a covenant that would directly protect the lender from the under-investment problem described above. This is because it would be impossibly intrusive to monitor a company’s failure to undertake particular investments. Instead it usually suffices to track investment policy indirectly, for example via minimum net worth or current ratio covenants.

■ For any desired degree of lender protection the least restrictive covenant should be used.

The above points focus on the costs and benefits of covenanting. While it may not be possible to quantify these costs and benefits, it is suggested that they are useful guidelines to bear in mind when negotiating a contract.
Types of covenants

The main covenants usually found in UK bank loan agreements cover non-financial and financial covenants as well as events of default, which can be triggered by covenant violations.

- **Non-financial covenants** Four important non-financial covenants are:
  - Negative pledge: this prevents the borrower from giving some future lender prior security over its assets.
  - Guarantees provided by members of a group of companies for the debt of other members of that group.
  - An undertaking to supply the lender with periodical financial information. Over and above the annual audited accounts, management accounts are the most frequently required, often on a quarterly basis.
  - Restrictions on capital spending, acquisitions and asset disposals.

- **Financial covenants** The most common financial covenants used in UK bank lending stipulate minimum net worth, interest cover and gearing (ratio of borrowings to net worth). Current ratio, cash flow ratio (e.g. cash flow interest cover) and asset disposal/net worth covenants are also used, although less frequently. By way of contrast, gearing and asset disposal/asset covenants tend to predominate in UK bond and debenture issues, whereas direct dividend restrictions are common in US private lending agreements.

Events of default

Events of default are those events, which, should they occur, permit the lender to require all amounts outstanding to become immediately payable. The typical events of default clauses are:

- Failure to pay amounts owing to the lender when due.
- Failure by the borrower to perform other obligations under the loan agreement. It is due to this clause that a covenant violation triggers an event of default.
- Any representation or warranty made by the borrower proving to be untrue.
- Cross-default, i.e. where the borrower has triggered an event of default or has actually been put into default on any other loan agreement.
Where a ‘material adverse change’ has occurred in the borrower’s financial or operating position. This is clearly a catch-all clause and there is a view that where a company has negotiated a meaningful set of covenants, it can legitimately refuse to accept a continuing material adverse change clause.

**Project financing covenants**

Because of the complexity of project finance, covenants in a project finance transaction are more complicated than those of a standard syndicated loan. They must cover all possible eventualities. The covenants are designed to:

- Ensure that the project company constructs and operates the project in the manner contemplated in the technical and economic assumptions that are the foundation of financial projections.
- Provide the lender with advance or prompt warning of a potential problem, whether political, financial, contractual or technical.
- Protect the lender’s liens. These include covenants that the project will be constructed on schedule, within the construction budget and at agreed-upon performance levels; be operated in accordance with agreed standards; that project contracts will not be terminated or amended; and comply with operating budgets approved by the lender.

Covenants in a project finance loan agreement include many of the same covenants required by lenders in asset based loan transactions. However, unlike asset based transactions, project finance loan documents are designed to closely monitor and regulate the activities of the project company. Hence, there may be a bespoke nature to the covenants, the variety of which are only limited by the characteristics of the project being financed. Some of these are summarized below:

- **Reports on project construction and completion**  Progress reports are important in confirming that the project is proceeding as planned. These reports typically contain information on construction progress generally; status of equipment orders, deliveries and installation;
construction progress meetings; force majeure events; and target completion dates. Completion categories include *mechanical completion* (when the project is completed to the project specifications), *operation completion* (when the project is operated at the levels guaranteed in the construction contract, and within environmental requirements), and *final completion* (when all provisions of the construction contract have been performed and the last minor portions of the work such as clean-up completed).

- **Notice of certain events**  Project finance loan agreements may contain provisions obligating the borrower to provide notice of certain events, including litigation, defaults, termination, cancellation, amendment, supplement or modification of any governmental permit, licence or concession, in order to provide the banks with advance notice so that corrective measures can be adopted.

- **Maintain existence**  This is to avoid the phenomenon of ‘intentional bankruptcy’ – the borrower will agree to take all action necessary to preserve its existence. This means making required filings with governmental authorities and observing corporate or partnership formalities according to the laws of project company’s home country.

- **Maintain interest in project**  The project company will be obligated to maintain its ownership of the project for a negotiated period. This provides the lender with some comfort that the original equity investors will continue to be involved in the project.

- **Pay taxes**  All taxes and other governmental charges must be paid when due and payable.

- **Compliance with laws**  The project company will agree to comply with all laws applicable to it and to the project.

- **Obtain and maintain all approvals, permits and licences**  The project company will obtain and maintain all approvals, permits and licences necessary or advisable in connection with the project.

- **No merger or consolidation**  The project company will agree not to merge with or consolidate with any other entity. This is to ensure that the money is actually lent to the project entity and that the credit risks are not radically altered.

- **Engineering standards for construction and operation**  The project company commit to maintaining a specified standard of care and operation, typically ‘in accordance with good industry practice’.
- **Maintenance of properties**  The borrower typically commits to maintain the projects and the assets in good working order.

- **Environmental compliance**  The project company typically agrees to comply with the laws of the jurisdiction in which the project is located.

- **Insurance and insurance proceeds**  The project company will be required to obtain and maintain insurance to satisfy the requirements of the lender concerning form, creditworthiness of insurers, and suitability of named insured, loss payee and subrogation provisions, and other concerns.

- **Adhere to project performance documents**  The project company should agree to perform its obligations, and comply with each of the project documents, and not to intentionally create an event of default.

- **Amendment, modification, termination, replacement, etc. of project documents**  The project company will agree not to amend, modify or terminate, replace or enter into any project contract without the consent of the project lender.

- **Change orders**  Generally, significant changes, however, must be reviewed by the lenders to determine whether they affect the construction costs, schedule and reliability of the project and, if so, ensure that they do not cause an event of default.

- **Change of business**  The project company will agree not to engage in any business other than that assessed in the initial analysis – this is to avoid modifying the risk profile of the transaction.

- **Indebtedness**  Additional debt is not permitted without the approval of the project lenders. This is to avoid having the company’s debt service capability unduly eroded.

- **Investments**  The project company is prohibited to make any investments unless approval has been granted by the lenders.

- **Dividends and restricted payments**  Released profits to the sponsors should be closely controlled by the project lender. Once the money is released, the funds are not typically available for use at the project. Release of profits is typically conditioned, there not being any default and all amounts required to be on deposit in various reserve accounts being present and the debt service ratios being adhered to.

- **Mandatory prepayment on the occurrence of certain events from excess cash flow**  Project finance credit agreements typically contain
mandatory prepayment sections to allow the lender to have a priority claim on cash flow before any transfers can be made to the sponsors.

- **Financial tests**  Financial tests, such as debt service coverage ratios, minimum working capital requirements, net worth and the like, are the subject of negotiations that are typically tailored to the specific risks of the project. Financial tests can provide early indications of difficulties. One such test is the debt service coverage ratio; however, it is seldom viewed by project lenders as the only necessary covenant.

- **Special milestone dates**  These may include dates that relate to construction deadlines and termination dates under off-take purchase agreements. These are incorporated into the loan agreement with covenants requiring the borrower to take required actions if the action has not been completed by the date specified.

- **Change in the project**  The company may be prohibited from changing or altering the project. In such cases, the definition of ‘changes’ should be clearly defined in the loan documentation. Changes for example consist not only of the type of business but also the scale or production volumes.

- **Project support**  The borrowers may require that the project company supports the project in all respects, including completion.

- **Financial reporting**  This covenant requires the company to provide appropriate accounts to the lenders: audited annual statements, interim statements, pro forma statements, quarterly or monthly statements, internal management accounts, etc. It is essential to specify if the statements are to be audited, and if so, in accordance with internationally recognized standards (e.g. IAS).

- **Use of proceeds**  The project company will covenant that loan proceeds will be used only for their intended purpose (to be specified in the loan documentation). The project lender will want to avoid any use of proceeds for unapproved project changes or uses since that may be construed as assuming the liability in event of liquidation.

- **Security documents**  The borrower will covenant that it will take all action required to maintain and to preserve security structures created by the lenders.

- **Operating budget**  The project company is typically required to submit an annual project operating budget within 60 days of the beginning of the next financial year for approval by the lenders.
■ **Trustee accounts**  It is typical for all project revenues to flow through a revenue control account maintained by a trustee. This enables the lenders to monitor the income flows into the project. The borrower should therefore be required to establish this account and have all payments made to it transit via these accounts as a condition precedent to the loan agreement.

■ **Capital expenditures**  Similar to investments, the project company is prohibited from making capital expenditures for the project, unless approval is granted by the lenders. This is to avoid any siphoning or diverting of funds earmarked for the project.

■ **Transactions with affiliates**  Because the lender places restrictions on when profits can be distributed to the project sponsors, indirect distributions (for example, transactions with affiliates) are similarly disallowed.

■ **Construction cost overruns**  In the event of cost overruns, the loan documentation should oblige the project company to apply those funds in a specific order, often reserving for the last application the most expensive options for the project.

■ **Other covenants**  The loan agreement may contain other covenants, such as compliance with pension laws; limits on lease agreements; limits on sale and leaseback transactions, property disposals and transfers, etc.

### NPVs and cover ratios

Cover ratios have several applications in the credit agreement. There may be an event of default if a cover ratio in the loan agreement is breached. This may suspend or prevent the borrower from effecting subsequent drawdowns under the loan facility. Moreover, the interest margin payable by the borrower may vary depending in function of the cover ratio level.

There are several types of cover ratios and each can have a specific purpose in the project financing loan documentation:

■ **The project life cover ratio**  This ratio measures the NPV of the project to bank debt outstanding on any particular day.

■ **The loan life cover ratio**  This ratio measures the NPV of the projected revenues during the period it is estimated that the bank debt will
remain outstanding (the ‘loan life NPV’) to bank debt outstanding on any particular day.

- **The drawdown cover ratio**  This ratio measures the loan life NPV to the total to be borrowed from the banks (the ‘peak debt amount’). If this cover ratio is used, it will be precedent condition to the drawdown of any loan that the required drawdown cover ratio is not breached.

- **The repayment cover ratio**  This ratio measures how much needs to be repaid under a credit agreement on any given repayment date. A borrower would be required to repay an amount to ensure that the repayment cover ratio would be within its required level (say 1.75:1). This ratio can also be used as a trigger to an event of default, e.g. if the ratio falls to say below 1.4:1.

### Control accounts

Control accounts enable the bank to control withdrawals by the borrower. Such accounts typically gather all payments to the company and enable the banks to exercise control over payments from the account. Banks will have security over any control accounts maintained in connection with the credit agreements. Such control accounts are typically structured as in the trustee accounts in Figure 2.3 ‘Project financing supported by a throughput contract’. Some types of control accounts are:

- **Disbursement account**  The proceeds of all loan drawdowns and of all equity subscriptions would be paid into a disbursement account. Withdrawals would be permitted to fund construction costs. Disbursement accounts are used when banks want to control the disbursement or advancement of funds to the borrower. Withdrawals typically are subject to producing agreed supporting documentation (receipts or orders).

- **Proceeds account**  All project revenues should be paid into a proceeds account and withdrawals, whether for operating purposes or dividend payments, made contingent upon obtaining approval from the lenders. This is to ensure that funds are not siphoned off to the benefit of the sponsors and weaken the project entity.

- **Compensation account**  Compensation accounts are designed to isolate compensation payments (e.g. equipment damage, insurance claims,
etc.), again, so that the lenders can monitor the flows into the project and ensure that the funds do not end up in the wrong place.

**Debt service reserve account** Debt service accounts are designed to create a reserve fund which is used to make interest and principal repayments should the project cash flow exhibit unforeseen adverse variations (e.g. a production blockage).

**Maintenance reserve account** This account is designed to build up a reserve to cater to cyclical maintenance of the project (say five or six years in the case of power plants). Banks would seek to ensure that funds be set aside from ongoing operations in order to be able to service the infrastructure at given intervals.

### Events of default

Events of default in a project financing are similar to those in any classic commercial lending situation. These include technical defaults (representation and warranties, notices, delivery of financial information, notice that a subsidiary has disposed of assets, creation of liens), financial events of default (violation of a financial ratio covenant) and mechanicistic events of default (non payment of interest or principal). Many of the events of default in a project finance credit transaction are due to poor housekeeping, some are minor warning signals, and others indication of deep-seated problems. Events of default specific to project finance transactions and not typically present in commercial lending include:

**Payment** As in any loan agreement, non-payment of interest or principal constitutes an event of default. Since project finance is unlike most other types of financing, the creditworthiness of third parties can affect the financing. Accordingly, payment defaults by another project participant under a project financing may be included as a credit agreement default.

**Breach of covenants** A breach of one of the covenants is obviously an event of default. The lenders can then assess the defaults on a case by case basis, and decide whether they are remediable or whether they warrant intervention or, *in extremis*, restructuring.

**Breach of representation or warranty** A breach of a representation or warranty set forth in the credit agreement also constitutes an event
of default. It is up to the banks to determine whether such a breach poses a serious threat to the project’s viability.

- **Filing of bankruptcy petition**  If any of the parties in a project financing (the project company, sponsors, contractor, operator, off-take purchaser or supplier), files a petition for bankruptcy or takes similar action, it is an event of default. This enables the banks to adopt early corrective actions.

- **Judgments**  Final judgments rendered against the project company, any project sponsor or any major project participant are considered an event of default should they be in excess of a negotiated minimum amount. Like other events of default that include entities other than the project company.

- **Final acceptance date**  If the project completion date, typically called the final acceptance date, does not occur by a certain date (based on the construction schedule agreed to in the construction contract and on the milestone dates in major project contracts, such as an off-take purchase agreement.), this can be considered an event of default.

- **Government approvals**  Failing to obtain, maintain, renew, or replace government approvals or permits can also be considered an event of default. The borrower will naturally seek to limit the coverage of any such events of default to events that threaten the viability of the project or ability to perform its obligations under the credit agreement.

- **Abandonment**  Abandonment of the project by the project company is an event of default.

- **Expropriation**  An expropriation, whether a complete taking or an act of ‘creeping expropriation’, is an event of default.

- **Ownership and control**  Failure of the project sponsors to maintain either an agreed-upon ownership interest or voting control of the project company is an event of default. The purpose of this clause is to ensure that the original equity investors remain committed to the project, maintaining the original risk profile.

- **Payment of obligations**  If the project company, any project sponsor or any major project participant, such as the contractor, operator, off-take purchaser or supplier, defaults in a payment obligation in excess of a specified amount, this can be considered an event of default. The borrower will want to limit the reach of this event of default to only those failures that could reasonably be expected to have a material
adverse effect on the project, or the borrower’s ability to perform its obligations under the credit agreement.

- **Breach of credit support**  If any party to a credit support document, such as the sovereign under a sovereign guarantee, or any credit support obligation under a project contract, is not paid when due, this will constitute an event of default. Providers of subordinated debt and parties obligated to make capital contributions are included in the scope of this default.

- **Security documents**  If any security document, such as a security agreement, stock pledge agreement or mortgage, ceases to be in full force, or is no longer effective to create a first priority lien on the collateral, then an event of default occurs.

**Conditions precedent to closing**

Before a lender agrees to advance funds to a project company it will require that the borrower satisfies certain conditions known as ‘conditions precedent’. Typical conditions precedent are detailed below:

- **Host government concessions and licences.**
- **Off-take agreements.**
- **Supply agreements.**
- **Construction contract and issuance of the notice to proceed.**
- **Operation and maintenance agreements.**

The above elements all need to be in a form acceptable to the lender, be authorized, executed and delivered to the project company by the operator, and be enforceable against the operator in accordance with its terms.

- **Permits**  The lender will require certified copies of all governmental actions, filings, permits and approvals necessary for the ownership, construction, start-up and operation of the project and the related facilities.

- **Insurance and insurance consultant’s report**  The lender will require copies of all insurance policies required by the terms of the credit agreement and the other project documents.

- **Real estate**  Where available, it is customary for the lender to obtain land surveys of, and title insurance on, the project site and other real estate interests important to the project.
Financial statements of project company, project sponsors, guarantors and major project participants These must be submitted to the lender in order to assist the lender in determining whether these entities are sufficiently creditworthy to perform their role in the project financing.

Construction budget and construction drawdown schedule Periodic reporting on these elements enables the borrower to monitor the project during the construction period, including costs required to complete the project and funds available to do so.

Construction reports A report prepared by an construction firm acceptable to the lender must be submitted. This report analyses technical and economic feasibility of the project.

Consultants’ reports Specialist reports are often required by the banks in order to enable them to assess technical minutiae which they are unfamiliar with.

Environmental review In most countries, project lenders will require some form of environmental audit and report by an environmental consultant.

Legal opinions Lawyer’s opinions are needed to ensure that due diligence has actually been performed by competent, careful counsel. Legal opinions address matters such as due organization, due authorization, ability to execution and delivery of financing and project documents, enforceability and conformance with legislation.

No material adverse change On the closing date, there must be no material adverse change in the financial condition of the project sponsors, or any related parties.

No defaults The borrower must certify that there does not exist, on the closing date, any default or event of default under any of the project contracts.

No litigation The borrower must certify that there is no litigation in existence which relates to the project or its various participants.

Intercreditor agreement

Intercreditor agreements are used where there is more than one class of debt and where those classes of debt have different interests in the same
collateral. The intercreditor agreement also generally provides that only
the agent bank is authorized to negotiate on behalf of the participating
banks and grant waivers to the borrower. This is to prevent individual
banks from initiating individual actions.

Security agreements
Lenders' security concerns
The main issue concerning lenders regarding security is the ability to
take effective control over the contracts and keep them in place to enforce
security. There are several documents do to this.

Security documents
Some of the documents that might need to be entered into to create or
record the required security interest are:

■ mortgages or fixed charges over land, buildings and other fixed assets;
■ fixed and/or floating charges over moveable assets, and production/
  work in progress;
■ assignments of rights under underlying project documents (e.g. con-
  struction contracts, performance bonds, licences and joint venture
  agreements);
■ assignments of project insurances and brokers’ undertakings;
■ assignments of sales contracts, take-or-pay, throughput or tolling agree-
  ments escrow accounts to control cash flows relating to the project;
■ assignments of long term supply contracts;
■ assignments of project management, technical assistance and consult-
  ancy agreements;
■ pledge of shares of project company, including charge over dividend
  rights.

Security on specific tangible assets
In many projects there will be some specific tangible assets. It is unlikely
that the realisable value of such items in a project financing would be of
great significance in relation to the overall debt, but they do have value. The assets specifically charged will usually include the following:

- **The tangible assets used in the facilities**, e.g. oil production equipment, machinery and other moveable assets.
- **Fixed assets (land, buildings and other fixtures of the project)**. Since foreign lenders may not be able to acquire interests in property, it may be necessary to develop a security structure with local financial institutions to hold the security for the benefit of the syndicate via sharing arrangements.
- **The licence or other operating permits**. These are usually required to be held by a local national and are therefore not usually assignable or transferable without the host government’s approval.
- **Technology and process licences**. Lenders will want to be able to transfer the rights to technology or process licences in order to be able to sell the business as a going concern. It is important not to separate the two since the technology may be worthless without the business assets and vice versa.