IN-DEPTH

Project Finance Law

LENDERS' RELATIONSHIPS WITH PROJECT COUNTERPARTIES

Project Finance Law

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Lenders' Relationships with Project Counterparties

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Introduction to project agreements

Central to any project financing are the project agreements or project documents: the contractual arrangements the borrower enters into for the development, construction, operation and maintenance of the underlying project. Depending on the type of project and its stage of development or operation, project agreements may include construction contracts, supply agreements, operation and maintenance agreements and offtake agreements, among others. There are three primary reasons why it is imperative for lenders to understand, evaluate and preserve the project agreements:

1. they are the primary components of the project's value;
2. they form the basis for credit extensions under the credit facility (whether during construction in the form of construction loans and letters of credit to support the borrower's performance obligations under the project agreements or during operation in the form of working capital loans and letters of credit for similar support); and
3. lenders receive a security interest in them as part of the non-recourse financing structure.

Unlike other secured lending transactions, the primary value underlying a project financing is given by the revenue streams generated or expected to be generated from the project. With potentially limited value stemming from the physical assets, a lender maintaining the project as a going concern means maintaining the contractual rights and relationships that allow the project to be built and to operate, both during the term of the credit facility and in the event of foreclosure. Because of the nature of project financings, it is the obligations of the borrower under the project agreements that create the basis for certain credit facilities and extensions. For example, under many project agreements, because the borrower is not an otherwise creditworthy entity, the borrower may be required to provide performance security to its counterparties. In lieu of providing cash security, the borrower will enter into a letter of credit facility with lenders who will issue letters of credit to the project counterparties as beneficiaries of those letters of credit. For projects under construction, the construction contracts will contain key milestones and conditions to payments and, by extension, draws under the credit facility. Consequently, it is important for lenders to understand the terms of such project agreements and protect themselves against risk from non-consensual amendments or modifications, including through change orders during construction.

The nature of non-recourse financing results in heightened importance of timely construction of the project (on budget and in accordance with the performance parameters established in the underlying construction contract) and the project's continued operation throughout its expected life so that the project's revenues are actualised. Therefore, prudent lenders will require the grant of a security interest in all project agreements of the borrower as part of the collateral package so that, in the event of a default, lenders (through their agent or another designee) are able to take assignment of project agreements and step into the shoes of the borrower thereunder. This has two implications for lenders in practice. First, lenders must understand whether the project agreements permit this

assignment. Second, and most importantly in the case of material agreements, they must seek contractual privity with counterparties and receive the prior consent of those counterparties to step in and cure defaults prior to exercising the last-ditch option to foreclose.

For lenders, evaluating and preserving the project agreement structure and mitigating possible risks associated therewith is addressed through due diligence, by examining how the finance documents with the borrower are drafted and, in many cases, by entering into direct agreements with the applicable project counterparties. These are not mutually exclusive options and lenders should, and do, use them in combination with each other.

Understanding and evaluating the project structure through due diligence

The first step in any project financing is due diligence of the borrower and the project. This includes understanding and evaluating the project agreements and project counterparties. Due diligence is a multifaceted process. Through consultants, counsel and internal experts, lenders should evaluate the major risks they would assume, including market risk, construction risk, operational risk and contractual risk. In each facet of diligence, the analysis will inevitably turn to the risks intrinsic in project agreements from possible non-performance of both the borrower and the counterparty. In transactions where project agreements form all or part of the basis of the credit facility, such as facilities under which letters of credit will be issued or where payment obligations under construction contracts require draws by the borrower, lenders should evaluate the circumstances, timing and likelihood of draws on the applicable loans or letters of credit to better understand and assess the risks of the project.

In addition to providing lenders with an overall picture of the applicable project agreements, diligence also, importantly, allows lenders to determine which project agreements are material. A contract's impact on the construction of the project, the projected performance of the project, the revenue stream of the project once operational (i.e., the financial impact of a termination or other impairment of the applicable project agreement) and the replaceability of the contract (i.e., in the case of a supply or an offtake agreement, the presence of a robust spot or merchant market, or, more generally, the willingness of other creditworthy counterparties to enter into replacement contracts on similar terms) are typical ways for lenders to evaluate materiality. Essentially, if the borrower's contractual rights under a particular project agreement are necessary for the timely and cost-effective construction of the project, the operation of the project in accordance with applicable law or the maintenance of the revenue stream of the project, and the project agreement cannot quickly and readily be replaced with a comparable contract, that project agreement is a material contract. In practice, material contracts are likely to include key construction contracts, offtake agreements, interconnection agreements (if applicable), operations and maintenance agreements, and services agreements. The designation of a contract as material allows lenders to identify which project agreements require specific conditions, covenants and events of default under the financing documents and which project agreements should be subject to a direct agreement with the lenders (or their agent) to adequately address risk.

During the diligence phase, the rights of lenders and the process of information gathering and utilisation is heavily dependent on the status of the project (i.e., whether it is yet to be constructed or is in operation). Legal due diligence for the project financing of a project under construction often consists of reviewing advanced drafts of, rather than executed and effective, project agreements. With the agreements still subject to negotiation between the borrower and its counterparties, lenders can flag risks in the draft agreements and work with the borrower to mitigate those risks prior to execution. Required changes to project agreements may include, for example, modifying counterparty termination rights, increasing counterparty performance security obligations or agreeing to a form of direct agreement. In the event that those changes are not accepted, or the applicable project agreement has already been executed, the lenders may still address such points through the terms of the loan agreement, namely the covenant package, and the direct agreement with the counterparties (in which modifications to the applicable contract can sometimes be agreed, rather than through an independent amendment). In financings for operating projects (or projects nearing operation) where the project agreements typically are fully negotiated and executed, there is limited ability for lenders to request changes to any particular project agreement (though, in the case of a fatal flaw, lenders may still require modifications to a contract). In those cases, the covenant package and the direct agreement become the primary tools of lenders to mitigate risk.

Preserving the project agreement structure through credit agreement provisions

The broad understanding of the project agreements achieved through diligence – including identification of material project agreements and risks – primarily impacts four key sets of provisions of a credit agreement in any project financing: the representations and warranties; the conditions precedent; the covenants; and the events of default.

Representations and warranties

Representations and warranties provide lenders with factual statements about the project agreements and the performance of the borrower and counterparty thereunder. Typical representations and warranties with respect to project agreements include:

1. a list of all agreements to which the borrower is a party;
2. a statement that all project agreements are in full force and effect, and there are no other project agreements than those that have been provided to the lenders;
3. a representation that, to the borrower's knowledge, the counterparties' representations and warranties in the underlying project agreements are true and correct;
4. a representation that all information provided by the borrower to the lenders' third-party consultants is true and accurate in all material respects, and that there is no default or other adverse events (such as force majeure) under the project agreements; and
5. a representation from the borrower that the financing will not contravene or result in a lien under the project agreements.

While the inclusion of representations and warranties covering the above matters is standard, there are still significant points of negotiation between lenders and the borrower, particularly when the representations and warranties speak to the actions or statuses of other parties. From a lender's perspective, it would be ideal for all representations to be 'clean' – that is, the representations would not be subject to any qualifications. Borrowers, understandably, resist giving such representations without qualification. In practice, the solution for representations relating to project counterparties or project agreement outside the borrower's control is often for the parties to agree to limit these representations to the extent of the borrower's knowledge (though to what extent is still heavily negotiated). However, where borrowers are in control (for example, with a statement that the borrower is not in default under a given project agreement), lenders should resist any attempt to include a knowledge qualifier.

In addition to knowledge qualifiers, borrowers will negotiate thresholds for representations requiring the listing of project agreements and may also seek to limit non-contravention and no lien representations to only the agreed material project agreements. Finally, borrowers often seek to subject their representations to a materiality qualifier. This qualifier can take the form of general materiality (e.g., that there are no material breaches under the project agreements) or material adverse effect (MAE) (sometimes called material adverse change). While MAE is often a heavily negotiated concept, at its most basic level it means that the representation is true and correct except for non-disclosed items that do not have a significant impact on the operations of the project or borrower.

Representations and warranties for project agreements serve several purposes. First, they act as a confirmation of diligence. The list of project agreements proposed by the borrower (typically attached as a schedule to the credit agreement) should confirm the lenders' understanding of the suite of contractual arrangements for the project and, in instances where there are discrepancies, allow lenders to conduct diligence on any newly disclosed contracts prior to execution of the financing documents. Second, accuracy in all material respects of representations and warranties is typically a condition to the effectiveness of the credit agreement and to each extension of credit thereunder. Finally, as discussed further below, a breach of a representation (occasionally subject to a cure period) in any material respect is universally an event of default under a credit agreement.

Conditions precedent

The conditions precedent to a credit agreement provide another opportunity for lenders to address risks associated with project agreements. Conditions precedent are actions or events that must occur prior to the effectiveness of a lender's (or other creditor's) obligations to extend credit under the applicable debt documents. There are several customary conditions precedent in respect of project agreements that the parties will typically expect to include in the credit agreement. These conditions include, among others:

1. the execution and delivery of direct agreements with specified counterparties and delivery of any legal opinions required thereunder;
2. receipt by lenders of all validly authorised and executed project agreements (which such project agreements must be in a form satisfactory to lenders);
3.

a requirement that the project agreements are in full force and effect without any undisclosed amendments; and

4. compliance with and no default under the project agreements by the borrower and the counterparties thereto.

Additionally, as mentioned, lenders will expect the borrower to certify that all representations and warranties (including those related to the project agreements and counterparties) are true and correct in all material respects.

Fundamentally, the purpose of these customary conditions precedent is to provide lenders comfort and satisfaction with the form and status of the project agreements, and with the borrower's and its counterparties' performance thereunder. Further, lenders seek to ensure that all documentation with respect to the relationship between lenders and project counterparties is in full force and effect and has been provided to the lenders – in other words, the lenders want certainty that all important project agreements were provided to them during the diligence process and that the lenders have any required rights (through a direct agreement) under material project agreements. In each case, lenders want to establish a satisfactory system prior to incurring exposure to the borrower.

Conditions precedent also provide lenders the opportunity to mitigate risks unique to each project that may not be addressed by the customary conditions precedent found in most credit agreements (e.g., delivery of certain amendments of or additional credit support by the counterparty under a project agreement). Conditions precedent will be developed over the course of due diligence, allowing lenders to address unacceptable risks specific to the project or its project agreements prior to the effectiveness of any project financing.

Covenants

While representations and warranties provide statements of fact allowing lenders to assess the project agreements and evaluate the risks that they are willing to take, and conditions precedent protect lenders from risks they have not had the opportunity to assess prior to funding, the covenant package provides forward-looking protection to preserve project agreement arrangements during the term of the financing. Project agreements are addressed in both the affirmative covenants and negative covenants found in any project finance credit agreement.

Affirmative covenants

Affirmative covenants protect lenders by requiring the borrower to take specific actions with respect to the project agreements. A common subcategory of affirmative covenants is information covenants requiring the borrower to deliver to lenders certain notices or other correspondence received or delivered by the borrower in respect of the project agreements. Such notices often include:

1. notices of default or breach under the project agreements;
2. notices of force majeure or other material events (such as casualty or condemnation events); and

3. notices of any action or threat of action against a material project counterparty.

In some cases, especially in transactions involving new technology or where greater oversight is needed, lenders may also require borrowers to provide copies of all correspondence under the project agreements that are outside the ordinary course of business. In all cases, these information covenants allow lenders to remain promptly informed of any material developments at the project.

In addition to information covenants, the affirmative covenants commonly include a requirement that the borrower comply with its obligations under the project agreements. Without such affirmative covenants, lenders are at risk of situations where they are obligated under the financing documents to extend credit to a non-performing borrower. Other common affirmative covenants include those that require the borrower to take all such actions necessary to ensure that any additional or replacement project agreements entered into become subject to the lenders' security interest.

Finally, the affirmative covenants may also include covenants specific to the project's status and nature of the financing. For example, if a key project agreement expires prior to the maturity of the credit facility, lenders may require the borrower to exercise any extension options under the agreement or otherwise enter into a replacement agreement with terms and a counterparty acceptable to the lenders.

Negative covenants

The most important covenants with respect to project agreements are the negative covenants. Generally speaking, negative covenants prevent the borrower from taking, without lender consent, certain actions that would otherwise disrupt or materially alter the basis upon which the lenders lent to the project. Central to this protection is the covenant against termination of, or material amendment to, the project agreements. This covenant restricts (subject to exceptions and materiality qualifiers) the borrower from terminating, amending or modifying a project agreement and also typically restricts the borrower's ability to assign or permit a counterparty to assign its rights under a project agreement. It is common for this covenant to prohibit the borrower from granting any consent or waiver in respect of a material obligation under a project agreement. For a project under construction, this covenant will generally also prevent material change orders under any construction agreement, making changes to the construction schedule or cost (which function like amendments to the main construction contract) subject to lender approval.

This termination covenant is generally subject to three qualifiers. First, it will only apply to those project agreements that were agreed as material. Second, borrowers often negotiate replacement rights. These replacement rights usually permit a period during which the borrower, without breaching the covenant, can enter into an acceptable replacement contract (with an acceptable counterparty) if the original contract is terminated early. The lenders and the borrower may even pre-agree to a form of acceptable replacement contract that is attached to the credit agreement or that must contain certain terms that are addressed in a schedule to the credit agreement. The replacement rights can be conditioned on the borrower executing a replacement agreement with a specified counterparty, a counterparty with specified levels of technical expertise and creditworthiness or a counterparty that is otherwise acceptable to lenders. Third, the

termination covenant generally prohibits only actions that would have a materially adverse effect on the borrower, with the extent and nature of that materiality qualifier often varying according to the overall importance of the underlying project agreement.

As indicated above, the qualifiers and the covenant generally do not apply equally to all material project agreements. For instance, the borrower may not be permitted to replace particularly important project agreements while retaining replacement rights with respect to other, less important project agreements. The lender consent threshold for such agreements may be a super majority, instead of a simple majority consent, or the MAE qualifier would not apply (such that lenders get a say over any amendment to or waiver under such contract, however important).

There are two additional negative covenants generally applicable to project agreements in a project financing. First is a prohibition on settling or compromising any material claim against a material project party, such as a construction contractor, offtaker or material service provider. Second is a covenant that prohibits the borrower from entering into any new project agreements involving new project expenditures. As with the other credit agreement provisions, the lenders may also require additional negative covenants based on project-specific material issues (e.g., a prohibition on the borrower materially amending credit support received from counterparties).

Events of default

The last section in a credit agreement that involves the project agreements is the event of default provisions. There are several standard events of default that implicate the project agreements or project counterparties.

First, there is a breach by the borrower of a representation. This event of default is commonly subject to a materiality qualifier (i.e., the applicable representation is breached in any material respect) and, in some cases, a cure period.

Second, there is a breach by the borrower of a covenant in the credit agreement. Depending on the covenant, the borrower may be granted a period to cure the breach. However, as matter of practice because they are entirely within the control of the borrower, negative covenants are not subject to cure periods. In the case of affirmative covenants applicable to the project agreements, the borrower is almost always granted a cure right.

Third, there is a default by the borrower or a specified project agreement counterparty under a project agreement or direct agreement, or the failure of any such project agreement or direct agreement to be, or stay, in full force and effect. In this case, the event of default is typically limited to material project counterparties. Further, the borrower often has a cure right for defaults or breaches of material project agreements by the applicable counterparties. This cure right, which allows the borrower an agreed period of time to pursue remedies against the defaulting counterparty, may be subject to additional qualifiers such as maintaining a certain financial covenant, funding any shortfalls in reserve accounts or unreimbursed letter of credit drawings and certifying to no other defaults or events of default under the credit agreement.

The final relevant event of default is an insolvency event of a specified project counterparty (e.g., the counterparty voluntarily or involuntarily files for bankruptcy). The counterparties implicated by this standard event of default are often the offtaker, the operator of the

project and, in the case of a project under construction, the main construction contractor. However, this list may vary depending on the nature of the contractual arrangements of the project. Unlike the bankruptcy of the borrower, or any pledgors or guarantors (which results in an immediate event of default), typically, there is an agreed period of time after the project counterparty experiences the insolvency event before it becomes an event of default under the credit agreement and, often, the counterparty's continuing performance of its obligations under the underlying project agreement during the bankruptcy may prevent the occurrence of the event of default. Further, the borrower is often granted a replacement right to replace the insolvent project counterparty. As with the cure right for project agreement defaults, the borrower often must meet additional qualifiers similarly to those detailed above to benefit from the replacement right.

Lenders generally want events of default in respect of project agreements and counterparties to be drafted as broadly as possible so they may be triggered at the first sign of financial distress, thus allowing lenders to mitigate losses and recover their outstanding loans sooner. However, as noted above, most borrowers push to have carve-outs and replacement rights to buy themselves time to solve the underlying issue.

Establishing contractual privity through direct agreements

The final – and perhaps most important – tool available to lenders to preserve the project agreement structure is a direct agreement. The direct agreement, which is often referred to as a 'consent' in US-based project financings, is a financing document between the lenders (acting through the collateral agent, who is appointed to enforce the lenders' security interest at their direction), the borrower and the project counterparty. Put simply, direct agreements are a consent to the collateral assignment of the project agreement. The project counterparty is consenting to the security interest in the borrower's rights to the project agreement that the borrower has granted to the lenders under a security agreement (or another collateral instrument). Even with respect to project agreements that by their terms expressly permit collateral assignment, lenders will request a direct agreement that includes the express consent to assignment.

As with credit agreement provisions applicable to project agreements, lenders and borrowers will negotiate the universe of counterparties from whom direct agreements will be required. Given the importance of direct agreements in ensuring that project agreements remain in force and the security interest granted in them remains valid, lenders will at the very least require them from the standard material project counterparties, such as engineering, construction and procurement contractors, offtakers and operation and maintenance providers.

While the principal elements of direct agreements are relatively standard and direct agreements are often treated as secondary documents in the course of financing negotiations, sophisticated counterparties who understand their importance will often negotiate them heavily. Some counterparties, particularly those that are experienced in project finance and knowledgeable as to what has been accepted in other transactions, have great success in pushing back against the standard provisions in a direct agreement. Without a direct agreement, lenders would not have a direct, enforceable contractual relationship with the project counterparties and thus would be exposed to the significant risk that the project agreement structure would not remain in place following foreclosure

or default by the borrower. As noted above, to ensure a smooth and efficient execution of a project financing, a borrower is well advised to pre-negotiate the requirements of a direct agreement with its project counterparties.

Lenders' rights under a direct agreement

In addition to consenting to the grant of the security interest, the direct agreement also provides lenders with certain rights against the borrower and the project counterparty with respect to the project agreements. A direct agreement will often require the counterparty to concurrently deliver to the lenders copies of notices sent to the borrower. Additionally, a standard direct agreement will grant lenders the right to cure any breach under the project agreement by the borrower. Cure rights are essential in any direct agreement because they ensure that the lenders do not lose the benefit of the underlying project agreement without the opportunity to fix the problems. Such cure rights are often subject to agreed time periods; the lenders will usually have a shorter time to cure defaults arising from the borrower's failure to make a payment owed under the project agreement than to cure those arising for other reasons. The cure rights in a direct agreement are often heavily negotiated with each project counterparty, as a counterparty may take the view that it has already negotiated appropriate cure periods with the borrower. To avoid some of this negotiation, a seasoned and sophisticated borrower will often look to negotiate a form of direct agreement as part of the negotiation of the underlying project agreement. This is the time when a borrower has the most leverage over its counterparty and, assuming it understands the needs of its lenders, can make negotiation of the direct agreement far smoother.

As with the borrower's covenants in the credit agreement, in the direct agreement, the counterparty itself will be asked to agree to refrain from terminating, assigning or materially amending the applicable project agreement without lender consent. This provides lenders direct recourse against the counterparty. However, this provision is often resisted by project counterparties, particularly if a form of direct agreement has not been pre-negotiated. As part of the give and take of the negotiation, lenders will often live without the provision preventing the counterparty from amending the project agreement and must instead rely on its covenants on the borrower in the credit agreement.

Step-in and substitute owner provisions

Direct agreements allow lenders to seek the project counterparty's pre-agreed recognition of lender enforcement rights. Under the step-in rights and substitute owner provisions, lenders (or their agent or other nominees) are granted the right to temporarily or permanently step into and perform the borrower's rights and obligations under the project agreement. If the step-in rights are permanent, then the direct agreement should contain a mechanism whereby the lenders can require a novation of the relevant project document to a third party. The object of these provisions is to preserve the value of the project as a going concern in the event of foreclosure.

In the event of a foreclosure by the lenders, the substitute owner provision will permit the applicable purchaser in a resulting foreclosure sale to be recognised as the successor to the borrower and perform under the contract. In this way, substitute owner provisions can facilitate the sale of the project by allowing the lender to transfer key project agreements

to the new owner. These provisions are typically heavily negotiated because project counterparties seek to mitigate the risk of unqualified substitute owners while lenders seek to preserve a broader market of potential buyers in a foreclosure. In consideration for the recognition of a substitute owner (other than the collateral agent as an interim owner), the project counterparty may seek specific parameters applicable to the proposed substitute owner. For example, the project counterparty may request certain creditworthiness and expertise standards, ensuring that the ultimate substitute owner is reasonably capable of operating the project and meeting the obligations under the project agreement.

Additionally, as a condition to recognising a substitute owner or permitting lender step-in rights, the project counterparty will frequently negotiate the direct agreement to require the lenders to cure any existing borrower defaults under the project agreement. Similarly, if the agreement is terminated as a result of the borrower's insolvency, the direct agreement's replacement provision will require the counterparty to enter into a new project agreement with the collateral agent (or a nominee thereof). This provision customarily requires that the replacement agreement be on substantially the same terms as the existing project agreement. The object of this provision and the provisions related to substitute owners is to preserve the value of the project as a going concern in the event of foreclosure.

Lastly, lenders should look for sufficient standstill periods during which they can consider whether or not to exercise the step-in or substitute owner rights after receiving notice of the borrower’s default. During the standstill period, the counterparty postpones its right to terminate a project agreement for the duration of the standstill. Lenders will want to ensure that the standstill period lasts at least as long as the period to exercise its cure rights.

Representations and warranties in direct agreements

Replicating provisions found in the credit agreement, the direct agreement also contains representations and warranties from the applicable project counterparty for the lenders' benefit as to the counterparty's status and the status of the project agreements – as discussed above, the borrower can usually only make qualified representations as to the counterparty's status and performance. Direct agreement will also require the project counterparty to deposit any payments under the underlying project agreement into the secured accounts established pursuant to the depositary or accounts' agreement for the financing. Further, the direct agreement will occasionally contain a covenant requiring the counterparty to continue to perform its obligations under the project agreement, although this covenant is often heavily resisted by the counterparty on the basis that it overrides many of the other negotiated provisions of the direct agreement. Finally, lenders may also request that the project counterparty's counsel deliver a legal opinion as to the enforceability of the direct agreement against the counterparty. This requirement is often a point of contention, as project counterparties resist the incurrence of additional expense (though lenders may accept an in-house counsel's legal opinion to assuage this concern) and liability attendant with delivering a legal opinion.

Lender–counterparty relationship without a direct agreement

The above discussion of direct agreements represents the standard project finance lender perspective and requirements. However, there are certain financing structures where lenders either do not have direct contractual privity or do not have an opportunity to

negotiate the terms of their direct agreements. For example, in 'portfolio' financings, where the borrower is a direct or indirect parent company of several project companies, lenders typically will not have contractual privity with project agreement counterparties. With the lack of contractual privity, lenders may still seek comfort from project agreement counterparties through estoppels. A typical estoppel will contain statements of fact on the status of the project agreement and the parties' performance thereunder. Further, the estoppel will address any consent rights or other assignment issues that may arise under the project agreement as a result of the parent company financings (i.e., if such financing is deemed to be an assignment under the project agreement) and will typically otherwise contain a short form acknowledgement of the financing.

Conclusion

With the value of the asset, and therefore the lenders' security package, derived substantially from the successful construction and ongoing operation of the project, project agreements and counterparties – not to mention the borrower's and lenders' relationship thereto – are the key elements to any project financing. To fully understand and mitigate the risks of, and to, the project agreement structure, it is imperative that lenders thoroughly carry out due diligence on the project agreements, negotiate key credit agreement provisions (in particular, conditions precedent and covenants related thereto) and enter into comprehensive direct agreements. Without this holistic approach, lenders face considerable risk of degradation in asset value during the term of the loan and in the event of any foreclosure or subsequent sale.

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