The Project Finance Law Review

Second Edition

Editor
David F Asmus

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THE PROJECT FINANCE LAW REVIEW

SECOND EDITION

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PREFACE

I am pleased to introduce the second edition of *The Project Finance Law Review*, which now includes new chapters covering completion guarantees, construction risk and dispute resolution and conflict of laws risk. This edition builds on the work from the inaugural edition, expanding both the scope and depth of the resource offered.

As noted last year, many of the classic project finance texts are becoming increasingly dated as the years go by, while project finance itself continues to evolve with the markets it serves. The purpose of this volume is to provide a living guide to project finance that will be updated on a regular basis, while still tackling the core project finance concepts that every practitioner needs to understand.

This volume seeks to cover the most salient topics while leaving scope for expansion into other key areas (such as mezzanine financing, government funding, and environmental, social and governance (ESG) issues) in future editions. As discussed briefly at the end of Chapter 1, all three of these areas have been in great flux, with newer funding sources (e.g., private equity, pension funds and sovereign wealth funds), changes in the bond insurance market and more substantial environmental restrictions (particularly with respect to climate change concerns) in effect at key lending institutions all combining to change the complexion of the project finance market. The next several years should bring increased clarity to all of these subjects, including particularly the future of project finance in the large oil and gas industry.

I would like to express my thanks to all of the authors of this second edition, and particularly those who have contributed new chapters or who undertook significant updates to their earlier work. Their efforts have allowed this volume to be more useful than ever as we enter a new decade facing increasing uncertainty in global markets, including the project finance market. It is the hope of all of the authors that this volume not only will be of use to all of its readers today, but also will continue to grow in scope and utility in the years ahead.

David F Asmus
Sidley Austin LLP
Houston
April 2020

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Part IV

Cash Flow, Collateral and Guarantees

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Chapter 11

COMPLETION GUARANTEES

Roberto A Fortunati and Daniel A Levi[1]

The purpose of this chapter is to underline certain characteristics that the completion guarantees may usually present, and certain issues that may arise, particularly in civil law countries. This work, while it may contain conclusions or hypotheses of general application, is based on the laws and practice of Argentina under which jurisdiction the authors are entitled to practise. The aim is for the main issues commented herein to be conceptually useful to practitioners while acting in cross-border transactions.

I OVERVIEW

Risk assessment is the main activity of the design and structure stages of project guarantees. Security interests will be created and perfected as a result of meticulous work that may ponder risk magnitudes and risk allocations. All risks should be properly allocated and covered to the satisfaction of the parties. Based on the assessment made, new parties may finally come into the scenario, such as political risk insurers, export credit agencies and insurance companies. The more financially and economically robust the project is, the easier the negotiation related to risk mitigation and allocation, and to the creation and perfection of security interests should be.

One of the main aspects focused on by the legal counsel in a project finance transaction is the adequate creation and perfection of a suitable package of guarantees to secure: (1) the construction of the project and its completion; and (2) the operation, management and maintenance of this project together with the generated cash to service the debt. Secure-debt service is the name of this game, but how to do it and where to put more attention may vary based on the laws applicable to this security package.

The structuring and negotiation of the security packages in project financing is done without making any specific reference to guarantees securing completion or other undertakings. This is a conceptual distinction that is mainly beneficial for commentators and practitioners to distinguish, which will be the collateral and the main purpose of any given guarantee.

To secure the construction of the project until completion is one of the major challenges for the practitioner. The existence of recourse, whether limited or not, against the sponsors may make the work less sensitive, but not less important.

The guarantees to be created to secure the construction of the project until its commission (completion guarantees) belong to the universe of security interests, which are conceived by the parties to reach the stage at which the project may start operating,

1 Roberto A Fortunati is a partner and Daniel A Levi is a partner at Estudio Beccar Varela.

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technically and commercially, to generate revenues in the business-like manner on which the project was planned. There are some additional guarantees more specifically created to secure that the flow of revenues to be generated by the project will be destined to service the debt, after paying the contemplatedoperating expenditures (OPEX) and capital expenditures (CAPEX). Usually, cash reserves are kept for a similar purpose. This precedent distinction of guarantees does not mean that the nature or substance of the security interests varies, but that they are created (at the same time) and perfected for a slightly different main purpose, as explained above.

Another main aspect that will necessarily require attention is the law that will govern the creation and perfection of any of the above-referenced security interests. In this respect, the fact that the law that will govern such guarantees corresponds to a common law country or to a continental law country will have a material impact on the conception of the guarantees. For it to be comprehensive, bankruptcy laws, laws of procedure as well as rules of international private law cannot be disregarded in this analysis.

II EXAMPLES OF COMPLETION GUARANTEES

The following is a list of the most common completion guarantees created in project financing taking place in Argentina. It does not intend to be comprehensive but only illustrative, as each project may present its own particularities and, further, the need to create different security interests over different collateral.

i Trust agreement

The trust agreement is created in Argentina pursuant to Section 1666, 1680 et seq. of the Argentine Civil and Commercial Code (CCC). The trust under Argentine Law is an agreement pursuant to which the trustor conveys the property of certain assets to the trustee, who undertakes to exercise such property rights for the benefit of the beneficiary appointed in the agreement, and with the final purpose to transfer such property rights to a third party. Under normal circumstances, the borrower, when the debt is totally served, would be entitled to receive the remaining assets or money resulting from the eventual sale of the project.

The trust under Argentine Law can be created as security, and it can be established in the agreement that the trustee pays to the lenders as the debt services. The trust under the Argentine Law creates a patrimony segregated from the ones on the trustee, the trustor and the beneficiaries (i.e., such patrimony is protected from any action of the creditors of these three parties).

The parties of this agreement are normally the borrower, the lenders and the trustee. The borrower assigns and conveys to the trustee (usually the security agent for the local guarantees) the fiduciary property, as security for the benefit of the lenders, of certain assets and rights inherent to the project, in particular all the facilities or real estate rights (to the extent possible), the material contracts, any rights to governmental licences, collection rights of certain project revenues, rights to collect indemnifications (e.g., from expropriation), insurances, tax reimbursements, etc. Essentially, all the material assets that may keep the project working.

Revenues are usually paid into offshore accounts, particularly when capital flow or FX controls are in force, and a portion of the collected funds is normally transferred to an onshore account or accounts in the amounts previously contemplated to cover OPEX and CAPEX.

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The trustee commits to act as such for the benefit of the lenders and other finance parties as ultimate beneficiaries of the trust.

ii Direct agreements or assignments of contractual position

Pursuant to them (CCC 1636 et seq.) one of the parties of a contract, the borrower, assigns to another (the lenders, the trustee or their agent for their guarantees), its position in the relevant contract. This assignment must be notified and accepted by the other party of the contract. Once the assignment is enforced, the assignor is replaced by the assignee and liberated from all its undertakings from the relevant contract unless this liberation is restricted.

The direct agreements, or assignments of contractual position under the Argentine Law, of the borrower in any material contract for the project like, for example, in the case of the engineering, procurement and construction (EPC) contractor, or the agreement for the operation, management and maintenance of the project, contractors guarantees, insurances, etc., is now contemplated in the CCC, Section 1636 et seq. Prior to August 2015, when the CCC became in force, this type of agreements was allowed in the framework of the freedom of the parties to enter into agreements that do not violate public order.

The creation of security interests has an important impact with regard to the applicable insolvency legislation. To have or not to have a security interest that can be invoked against other borrowers' creditors is of extreme importance. In this respect, a valid question is whether the direct agreements are a security interest or a mere contractual obligation. To convey such direct contracts into a trust as security under Argentine Law is a way to create a valid guarantee.

The use of direct agreements in jurisdictions like Argentina does not mean that in all civil law jurisdictions this is a free-from-doubt scheme. For instance, in *International Project Finance: Law and Practice*[2] it is said by Antoine Maffei and Jean-Renaud Cazali (paragraph 13.153) that 'the validity of direct agreements (in France) . . . upon the project contract being nullified, is, however, not free from doubt under French administrative law. Indeed, such an agreement would need to be a collateral contract . . . to avoid the nullification of the latter resulting from the invalidity of the direct agreement'. This work also refers to the fact that certain direct agreements have been challenged by third parties before French courts notwithstanding the fact that, recently, the administrative courts of Bordeaux confirmed their validity.

In Argentina, it is said that the use of direct agreements as a way to secure the replacement of the borrower by the lenders' agent or some other relevant third party, puts the lenders – or their agents – closer to the position of the creditor that will foreclose the pledge on the shares of the borrower, assuming the liabilities.

In a foreclosure scenario, local insolvency laws will be material to determine effectiveness of the guarantees. Probably the most 'acid' test, direct agreements are, as underlined in *International Project Finance* (paragraph 13.165), 'rooted in the Anglo-American legal tradition and structured on the basis of insolvency laws applicable in jurisdictions following that legal tradition, which are often considered as more creditor-friendly in comparison with the insolvency law applicable in civil law countries following the French civil code legal tradition'. The main issue in this case is to structure the direct agreements in a manner that

2 John Dewar (ed.), *International Project Finance: Law and Practice*, 2nd edn, Oxford: Oxford University Press, 2015.

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may not contradict the insolvency laws of the relevant jurisdiction. The bankruptcy laws (in particular, the existence of stay rules) may well be a source to challenge the step-in right that the borrower pretends to grant to the lenders.

The direct agreements (unless conveyed to a security trust) are not a guarantee but an enhancement of the lender's position to exercise its step-in rights. This is particularly important with regard to bankruptcy law.

iii Share pledge agreement

This is an agreement pursuant to which the parties create an *in rem* right as security pursuant to CCC 2219 et seq. Because of the book entry form of most of the companies' shares, it is normally a registry pledge as security of credit of the lenders.

This pledge is perceived as a defensive type of security. In theory, it will give the chance to step in to the borrower. However, because of the contingent liabilities of the borrower, this security is not perceived as the guarantee that will allow the lenders to exercise their step-in rights.

In book entry shares, the pledge is registered in the ledger before the custodian of it and in the share certificates, if any. In non-public companies, this registry is usually held by the same company, while share certificates, if any, are kept in the custody of the lenders or their agent. In the case of most public companies, *Caja de Valores* (securities depository entity) is the entity holding the shares registry of the shares of the borrower and no share certificates exist.

In Argentina, until foreclosure of the pledge, the exercise of voting rights on the shares still belongs to the shareholders. This is why the borrower is usually a party to the pledge agreement to undertake negative covenants with respect to any shareholders' decisions that might affect the lenders' interest.

iv Fixed chattel mortgages

The registered fixed chattel mortgage agreements created pursuant to CCC 2220 et seq. (and the Registered Pledge Law) on movable assets pertaining to the project is usually a guarantee to be entered into between the borrower and the onshore security agent, pursuant to which the borrower creates a first priority security interest for the benefit of the lenders on movable assets constituting the project. Machines, equipment and intangible property are typical assets subject to this pledge.

v Floating pledge

The collateral of this pledge (usually inventory, spare parts, etc.) is created pursuant to the Registered Pledge Law (Decree Law No. 15.348/46, as ratified, regulated and amended).

vi Mortgages

Like a pledge, this is an *in rem* right created as a security in which the collateral is real estate. The formalities for the creation and perfection follow the rules for the purchase of real estate (i.e., notarisation and registration requirements). The creation of *in rem* rights as securities must conform to the 'principle of determination' of the thing over which it will be created and the identification and maximum amount of the credit to be secured. This characteristic also applies to the creation of a pledge as security.

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vii Trust accounts

Trust accounts are a development of the Argentine practice, in project financing, in which a bank account is opened by a trustee and operated as such. Notwithstanding the legal feasibility of this type of banking account, and its wide use for a long time, recent tax developments sometimes transformed them into an inefficient legal instrument because of their fiscal costs (mainly when the trust account manages current payments before any default scenario exists). As an alternative to that, some lenders and borrowers prefer splitting the structure into two different trusts (one for managing payments in current scenarios and one for managing the project revenue in a default scenario) or using account management agreements (which are not strictly a security but where the bank of the account undertakes certain management commitments). Pledges over the bank account rights are still a controversial legal figure in Argentina and practitioners are more inclined not to use them.

viii Promissory note

Promissory notes executed by the borrower in accordance with Argentine Decree Law No. 5,965/63 in favour of the lenders is not an actual guarantee (we are not referring to the chattel mortgage promissory note). However, it is customary to request and grant promissory notes and such widespread practice takes place to allow the lenders to have a summary proceeding to collect the amounts due by the borrower, in case of default, and to have an easier way to request bankruptcy in an insolvency scenario. The issuance of promissory notes requires detailed work because they may reflect additional debt and duplicate tax costs.

III THEORY AND PRACTICE

The reason for a variety of completion guarantees to be created does not come from the fact that such guarantees are not legally good or practical enough, but from the circumstances that different guarantees address different collateral and scenarios, including the eventual insolvency of the borrower or any of its contractors, such as the EPC contractor.

Neither the creation nor the perfection of the completion guarantees under Argentine law can be qualified as complex even when perfection in some cases can be certainly burdensome. In general, completion guarantees can be simpler than other guarantees and can be put in place as relatively short term so as to achieve in due course the usual conditions precedent for the closing and disbursement of financings. In this respect, it is worth mentioning that even when the creation of security interests on receivables is now pacifically accepted among practitioners, and has been widely used, years ago it raised a number of legal issues and concerns that have been quickly overcome.

The experience of foreclosure or restructuring debt acquired under project finance in Argentina is very limited. Thus, the theory behind completion guarantees, even when it is favourably viewed by Argentine practitioners, has not been confronted often before local courts.

One issue that raises concerns is whether the proceeds of foreclosure of the guarantees or sale of the relevant collateral could be directly vested onto the lenders or their agents, instead of passing through a court or a bidding process. Under Argentine Law it is possible to achieve such direct vesting under certain circumstances and conditions.

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IV FORECLOSURE AND PRIOR AUTHORISATION REQUIREMENTS

In certain industries or sectors of the economy, particularly when the national state has a strategic view on it, the sale of the project requires a prior authorisation to be given by the governmental authorities who are directly interested in the technical and financial situation of the new owner or operator.

Sectors related to oil and gas or public service concessions are typical cases in which this situation appears. The issue of how to address the step-in rights of the lenders in these situations has been discussed in the past to the satisfaction of lenders and borrowers, and the requirements of applicable laws and concerns of the public authorities have been dealt with by formulas satisfactory to all the parties involved.

The prior approval of governmental authorities tends to be initially seen as a possible source of value destruction for the lenders and also for the borrowers, which in the end should be collecting the balance of the proceeds of sale of the project after the debt is repaid in full. Guarantees to be created with respect to collateral, such as the right to operate a given project related to sensitive industries, are usually discussed in advance – prior to creation – with the relevant authority.

V COMPLETION

The concept of completion has a very important implication, particularly in case of compromises assumed by the sponsors of a project finance structured with limited recourse against them. There is a clear business impact for the parties involved that derives from the termination of construction. It would imply the release of the sponsors from certain eventual commitments or undertakings. The release of eventual insurance policies or bank guarantees covering completion risks and, eventually, the termination of some other ancillary agreements will be also impacted by completion.

As anticipated in Section I, all securities will end up covering the repayment risk. However, while arranging a security package for completion, the key feature will be that it secures the completion of the construction of the project the same as will be defined in the common business terms for the financing (e.g., the commissioning of the given project or plant or the starting of the commercial operations, usually meaning the capacity of the plant or project to start generating revenues, as contemplated in the project). This stage would normally envision termination, the finishing of the construction coupled with the starting of the commercial operation of the project. Sometimes, however, these events do not occur at the same time.

Lenders may get an added level of comfort from the sponsors by receiving from them the compromise to add equity or financial support to cope with eventual technical or financial delays that may harm the timely beginning of operation of the project. This will certainly be an undertaking but not a guarantee. The use of appropriate and proven technology, efficient and creditworthy contractors bound by adequate agreements that would contemplate remedies in cases of delays, deficiencies and eventual insolvencies of the involved parties, as well as the existence of overrun costs, are also some of the contractual tools that would enhance the creditworthiness of the project.

As anticipated, prior to completion, sponsors may need to provide comfort to lenders in a manner and to the extent that will enhance the creditworthiness of the project. Eventually, this comfort might ease negotiations related to the creation of the security package. Such comfort is usually given in the form of additional equity or financial support from the

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sponsors or their parties (e.g., the government, insurers of different risks, off-takers contracts, pre-sell of by-products of the given project). Certain specific, but very standard negative covenants are certainly designed to help in this respect, such as: (1) not to acquire additional debt; (2) not to incur non-contemplated expenses or not granting liens; (3) not to enter into agreements; and (4) affirmative covenants mostly related to the actions and decisions expected to be adopted by the sponsors, coupled with subordination commitments.

As mentioned before, in certain cases, lenders could look for additional support from the sponsors (e.g., until completion, either in the form of guarantees or undertakings to be provided by them, or alternatively – and if available – governmental guarantees, or additional equity or financing support).

For example, the Argentine administration that ruled the country between 10 December 2015 and 10 December 2019 in the calls for bid process known as Renovar I and II, for the construction and operation of renewable energy plants – taking place during 2016 and 2017 – made available a scheme of governmental guarantees with the support of the World Bank. This scheme of guarantees was welcomed and adopted for several projects to ease the investment process in renewable energies, as well as to facilitate the bankability of them.

VI THE COLLATERAL

Timely service of the debt is the priority of the parties. To that end, the completion guarantees focus more on the value of the facilities and their ability to generate revenue (the collateral of the completion guarantees will be, among others, the facilities, all the parts, materials, equipment, and pieces not incorporated yet to the facilities, and the contracts to build them). After completion, the security interests will be more oriented to secure not only the source of the revenues but also their generation and application in the agreed manner.

Upon completion, the guarantees created to secure the flow of revenues and their application to service the debt become more significant to secure the repayment of the loans. This flow must be enough to keep the project working in a viable and sustainable manner at least during the term required to completely serve the debt acquired through project financing.

The period after completion – which is not the focus of this chapter – is also secured by a complex system of guarantees that in addition to the facilities and other assets related to the project will have as collateral the operating, management and maintenance agreements related to the facilities, and also commercial agreements and a constellation of offshore and onshore accounts where the flows of funds will be credited to and disbursed from.

As indicated, before completion, the value of the facility is a key factor considered by lenders, and to that end the focus of the lenders is more on the set of contracts related to the construction stage, as well as on the contractors and their technical and financial capacity to fulfil their undertakings. After completion, such focus shifts to the contracts that protect the project capacity to be operated in a sustainable manner and continuing to generate the expected revenues.

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VII VALUE OF THE PROJECT AND STEP-IN RIGHTS

Because project financing is predicated on the repayment of the debt with the revenues of the financed project, the existence of this project, as a unit capable of always generating the expected revenues, is of utmost importance. Thus, the creation and perfection of the security interests should not underestimate the fact that the eventual foreclosure of the guarantees should not end up in the dismemberment of the project itself. Thus, the scheme of guarantees to be created should allow the lenders to exercise their step-in rights at foreclosure, seizing the project as entirely possible in the framework of the applicable procedural laws (governing the foreclosure of the security interests) of the given jurisdiction.

In this way, the foreclosure of guarantees in more than one jurisdiction is clearly an option that might jeopardise the maintenance of the unity of the project. This subject is closely linked to how the security package contemplates the enforcement of the lenders (or their agent for the guarantees) and step-in rights. We will address this matter in the following paragraph.

The structure and content of the security package for any project should contemplate the capture of all the material assets of the given project (either to be completed or to continue operating in a proper business-like manner) and how the lenders will exercise their step-in rights in case there is a need to foreclose the guarantees.

Owing to the number of rights, credits, contracts and other assets involved in a project to be financed through project financing, the number of guarantees to be created and perfected is usually significant compared with the guarantees created in another financial transactions.

In part, this is because in civil law countries there is no catch-all assets' security interest that may play that role. In Argentina, the existence of the trust as security is a partial response to that need. In fact, the trust as security under Argentine law is usually coupled with other security interests created over any given collateral. The importance of this type of security interest comes from the need to secure to the lenders the efficient exercise of their step-in rights, which implies the need to organise the above-mentioned constellation of security interests over so many different types of collateral in a manner that may allow a complete one-shot seizure of the project in case such guarantees are to be foreclosed. In other words, to permit that the exercise of the lenders' step-in right may include at least as many as possible assets belonging to the project to maintain it as operative and capable to service the debt.

Due to the risks associated with the eventual insolvent situation of the borrower and other possible contingencies, step-in rights in Argentina have not been structured around the foreclosure of the shares of the borrower and neither has the use of stipulations in favour of third parties.

VIII EVOLUTION

Even when, from the structural perspective, the security packages are similar from one project to another, they have slightly changed along the years. Guarantees reflect changes in legislation as well as preferences of the parties. In any case, there is always a need to structure a security package that may preserve the value of the project even if the guarantees are to be foreclosed. In this respect, the best possible way to preserve value is to achieve the step-in right of the lenders or their agent without dismembering the project.

In Argentina, during the 1980s, the pledge of credits and the assignment of rights were tools considered appropriate to contribute to the achieving of the above-referenced goal. All went well until a defendant, on 3 August 1981, did not appeal a lower court ruling deciding

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against the validity of a pledge of future credits alleging that the credit should exist at the time of creating the pledge because of the fact that pledged credits should be evidenced in a physical title to be given to the creditor[3]. Thus, project financing in Argentina has had from then on to be structured using a different type of guarantees even when a later court ruling of the Commercial Court of Appeals of the City of Buenos Aires returned the confidence on the pledge of future credits[4].

To deal with the limitations and legal risks derived from the above-mentioned lower court ruling of the city of Santa Fe, project finance started to be structured around the trust under Argentine law, developed by practitioners from one article of the Civil Code referring to a trust different from the trust known under common law. The trust under Argentine law proved its usefulness in particular to secure receivables, and years later new legislation that promoted the securitisation developed the trust under Argentine law, giving more certainty to the prior practice. The trust has been a key guarantee in project finance since the early 1990s. The fact that the trust under Argentine law creates a segregated or allocated estate exposed the virtues of this institute also with regard to the eventual exercise of the step-in right to be granted to the lenders, as well as the insolvency laws of Argentina.

IX LOCAL PRACTICE

Having said all of the above, it should be fair to wonder whether, under the laws of Argentina, the menu of security interests is enough to create a trustworthy package of completion guarantees. We may conclude that the response is affirmative, and that a long and repeated use of such guarantees by local practitioners keeps them with a consistently favourable view in this respect, despite their preferences.

3 Re. Tecsa S.A., s/Concurso Comercial Preventivo, *Incidente de Impugnación del Informe Individual del Síndico respecto del crédito… Expte.* No. 805 – Año 1981 del Juzgado de la Sexta nominación, ciudad de Santa Fe, Provincia de Santa Fe. Not Published

4 Re. Banco Nacional de Desorolls s/tercerie au Union Carbide Argentina S.A.V. Petrolifera El Carmen S.A. s/ejecutivo. Cite online Revista de Derecho Comercial y de al Objectives, 1994, p. 32 (RDCO 1984032).

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Appendix 1

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Daniel Levi is a partner at Beccar Varela, having joined the firm in 2004.

His practice areas include corporate law, with particular focus in corporate finance, banking law, M&A and commercial contracts. Daniel has extensive experience advising on local and cross-border financial transactions, including loan facilities, syndicated loans, securitisations and project financings, acting either on the financial institutions' or on the borrowers' side. He works in fintech and impact finance matters. He also has a wide, relevant practice in mergers and acquisitions, including private equity and venture capital investments, and in transactions involving the sale of distressed assets.

Daniel obtained his Law degree from Universidad de Buenos Aires (2006) and a Master's in Finance from Universidad del CEMA (2011, with distinction). He also studied Negotiation at Harvard Law School (US, 2014) and Private Equity & Venture Capital at INSPER Institute (Brazil, 2016). He worked as foreign associate at Pinheiro Neto Advogados (Sao Paulo, Brazil, 2015–2016).

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