LawyerIssue

PROJECT FINANCE: THERE'S NO SUCH THING AS INDISPUTABLE PRINCIPLES…

March 7, 2016

1. **Project finance principles**

"*The equity investment is 'first in, last out'—that is, **in principle any losses that the project suffers are borne first by the investors, and lenders begin to suffer only if the equity investment is lost***", Edward Farquharson, *How to Engage with the Private Sector in Public-Private Partnerships in Emerging Markets*, p. 53.

"***Thus the investors' risk is the same whether the equity is invested early or late.***", E. R. Yescombe, *Principles of Project Finance*, p. 294.

An experienced project finance practitioner will probably recognize the above statements as basic and indisputable principles of a project financed transaction.

Indeed, it is (or it used to be) generally and consistently accepted among project finance practitioners and studiers that the first loss, in a project financed transaction, is always incurred by the sponsors of the project, for the maximum amount of the equity they undertake to bring to the project, and that the lenders' losses will only commence to the extent the equity brought by the sponsors is lost. The sponsors' liability is accordingly limited only in the sense that their contribution to the project is expressly provided for and limited to a maximum amount of equity. Sponsors and lenders are not therefore partners; the sponsors' risk is always, in relative terms, higher than that of the lenders that fund the project, primarily because the sponsors' return on the project is also greater than the banks' return. This is in line with one of the most elementary market rules: the greater the risk, the greater the reward and vice versa.

This is true irrespectively of whether the investors' contribution is made up front, pro rata/pari passu or back ended because this only concerns the timing of the contribution, not the corresponding amount: it relates to the when, not to the how much.

In fact, nowadays, lenders tend not to object to the equity being injected pro rata/pari passu or even at the end of the construction period or even later, and grant, in the latter case, an additional credit facility that replaces equity in the meantime, conditional upon the equity injection being the subject of a firm, legally binding commitment by the investors, i. e., duly secured, notably by providing bank guarantees or letters of credit. Postponement of the sponsors' contributions does not impact on the allocation of the risk inherent in the project as the sponsors "*credit exposure to the project is essentially the same as it would have been had it made its equity contribution to the project company in the usual way*" (upfront), (John Dewar, International Project Finance, p. 311).

1. **Not quite indisputable**

A recent dispute made however clear that there's no such thing as undisputable principles.

The facts:

- In 2008, a Portuguese company (a special purpose entity created for the effect, below "the Company") and the Portuguese State entered into a concession agreement for the conception, construction, financing, operation and maintenance, with toll, of a motorway in Portugal.
- In the context of the concession agreement, the Company, its shareholders ("the Sponsors") and a syndicate of banks ("the Lenders") entered into several agreements, including Facility Agreements – whereby the Lenders granted long term facilities and equity bridge facilities – and an equity subscription agreement according to which the Sponsors undertook to make additional capital contributions to a certain maximum amount.
- The actual payment of the Sponsors' additional capital contributions was partially deferred to the end of the construction period, but on first demand bank guarantees were provided as security for these contributions.
- Since the long-term facilities were insufficient to satisfy all the funding needs of the project up to the end of the construction, postponement of the aforementioned Sponsors' contributions implied additional short-term credit facilities, which would make it possible to overcome the aforementioned gap.

- The construction works were suspended by a preliminary injunction requested by a company claiming damages arising from the construction.
- Because the construction works were on hold and the Company could not assure that the completion date would occur on the estimated date or what impact the suspension would have on the feasibility of the Concession, the drawdowns under the Facility Agreements were suspended.
- The equity bridge facilities were not used in full.
- The Sponsors voluntarily made additional capital contributions but in an amount substantially lower than the maximum amount foreseen in the equity subscription agreement.
- In 2012, on the date foreseen in the equity subscription agreement, the lenders and the Company requested the payment by the Sponsors of the remaining amount of the additional capital contributions up to the full amount foreseen in the referred agreement, failing which the Lenders would enforce the bank guarantees.
- The Sponsors refused to pay the outstanding full amount, alleging that the amount of the additional capital contributions was unquestionably linked to the sums withdrawn under the equity bridge facilities.
- The Lenders therefore enforced the bank guarantees.
- The Sponsors however filled two separate injunctions against the Company and the banks which provided for the on first demand bank guarantees – but not against the Lenders who had to, by their own initiative, intervene in the proceedings as a third party – to prevent the enforcement of the bank guarantees, alleging that their obligation to make additional capital contributions was limited by the amounts withdrawn under the equity bridge facilities.
- One of the injunctions was granted, with the court actually analysing and interpreting the relevant clauses of the equity subscription agreement, despite the fact that it was deciding on the enforcement of on first demand bank guarantees. The other injunction was rejected and two of the Sponsors' bank guarantees were indeed enforced and paid.
- The Sponsors then commenced arbitral proceedings against the Lenders and the Company asking the arbitral tribunal to declare that the Sponsors had fulfilled their obligations under the equity subscription agreement and that no amount was due under the referred agreement and to declare that the Lenders and the Company, by requesting the payment of the full outstanding amount of additional capital contributions and enforcing the bank guarantees, had breached the equity subscription agreement. The Lenders on the other hand asked the arbitral tribunal to condemn the Sponsors to pay the total amount of additional capital contributions plus interests.

In summary, the Sponsors' thesis was based on three main arguments:

- That it resulted from the agreements and the Base Case (financial model) that the funding of the project would always have to respect a debt/equity ratio of 85/15 and a proportional and *pari passu* payment of funds, in the sense that the Sponsors could never be required to fund more than 15% of the total funds, even in the event of collapse of the project;

- That the terms of the equity subscription agreement restricted the required amount of additional capital contributions to the sum outstanding under the equity bridge facilities; and, finally,
- That the agreements contained no clause providing for mandatory prepayment or acceleration of the obligation to make additional capital contributions.

On the other hand the Lenders argued that:

- The Sponsors had undertaken to make additional capital contributions in the maximum amount foreseen in the equity subscription agreement irrespectively of the amount of debt service owed by the Company at any time or of the amounts disbursed under the equity bridge facilities;
- The Sponsors' risk is the same whether the equity is invested up front, pro rata or back ended (as in case) and irrespectively of the amount disbursed by the Lenders under the equity bridge facilities, because the debt/equity ratio only stands in normal conditions but does not necessarily stand when the project collapses, or of the amount disbursed under the equity bridge facilities (when they exist, as in case);
- The Base Case (financial model) cannot be used as an element of interpretation of the agreements – namely to limit the Sponsors' risk, by limiting the amount of the additional capital contributions to the amount disbursed under the equity bridge facilities – because it isn't made with that concern or purpose. The Base Case is nothing but a reference scenario which cannot be used in case of disruption of the construction works, suspension of the financing and collapse of the concession. The Base Case is not prepared to be applied or solve abnormal situations and can only be changed for the purposes of restoring the financial balance of the Concession. It is then irrelevant if there is in the financial model an operational connection between the reimbursement of the equity bridge facilities and the payment of the additional capital contributions.
- Once the Base Case of a project finance transaction and the debt/equity ratio are agreed, the Sponsors undertake, from inception, to inject in the project company the equity foreseen in the Base Case, i.e. equity equal to the difference between what would be, in the light of the aforementioned model, the amount of the total funding needs of the project and the amount of loans agreed to meet these needs (whether they should do so upfront, *pari passu* or at the end is a different issue).
- If a project needs to secure funding to meet costs possibly exceeding those contemplated in the Base Case, this is normally provided as contingency funding/standby equity.
- The additional capital contributions at stake corresponded to the equity required according to the Base Case: they are, accordingly, base equity (equity that must always be injected) and not standby equity (equity that must be injected only if certain circumstances occur).
- A back-ended project finance transaction includes an equity bridge component — a facility whose purpose is to bridge the gap created by the postponement of payment of equity until the date the equity is injected by the sponsors. It is because the sponsors undertake from the outset to make their contributions at a certain date in the future that the project company agrees a bridge loan for the intervening period; and not the reverse, i.e. the sponsors undertake to make their contributions

at a certain date in the future because this is the date of repayment of the bridge loan.

Both the Sponsors and the Lenders filled several legal opinions in support of their thesis.

In 2014, the arbitral tribunal issued its award which was entirely favourable to the Banks: the arbitral tribunal endorsed the Lenders' interpretation of the Equity Subscription Agreement and sentenced the Sponsors to pay the full amount of additional contributions foreseen in the equity subscription agreement and confirmed that the enforcement of the bank guarantees by the Lenders was entirely licit and compliant with the equity subscription agreement.

The Sponsors then filed a request to set aside the arbitral proceedings – still pending – mainly sustaining violation of public policy's principles, the main argument being that the arbitral tribunal, by arguing that the obligation of payment of additional capital contributions also had a function of guarantee of the Lenders' credits over the Company violated the Portuguese rule according to which surety must be expressly declared because such rule applies to all personal guarantees.

The Lenders argued in response that (i) the referred obligations are not and were not considered by the court as personal guarantees; (ii) in any case, such obligations were expressly declared; (iii) in any case, the Portuguese rule regarding surety does not apply to other personal guarantees; (iv) in any case, such rule could not be considered as an international public order principle not only because the Portuguese rule has no specific correspondence to other countries rules regarding surety but also because in other countries' courts and authors also defend that such surety's rules do not apply to personal guarantees.

Despite all Sponsors' creative attempts not to comply with their obligations, postponing the payment of the full amount of the additional capital contributions, at the end the abovementioned principles were reinforced as basic principles of project finance transactions.

Bio

Filipe Lowndes Marques

Partner at Morais Leitão, Galvão Teles, Soares da Silva e Associados

Email: flmarques@mlgts.pt
Tel: +351 213 826 601

Filipe Lowndes Marques is a member of the banking and finance team and has extensive experience in the area of project finance, having worked since 1995 on several types of projects, including bridges, motorways, power plants, wind farms, football stadiums, LNG terminals and natural gas concessions. He has also been active in the field of capital markets, having advised on several securitization transactions, covered bonds issuances and worked on several IPOs of state owned companies. Filipe has been selected by Best Lawyers 2016's edition as "Leading Lawyer in Portugal" in Banking and Finance.

Bio

Francisco Cortez

Partner at Morais Leitão, Galvão Teles, Soares da Silva e Associados

Email: fcortez@mlgts.pt
Tel: +351 213 817 455
Francisco Cortez coordinates one of the litigation and arbitration teams as well as the sports law team and is a very experienced lawyer in the litigation area, specializing in civil, corporate and commercial litigation. He has been responsible for several highly complex cases, both in judicial courts and arbitration. As a lawyer and as an arbitrator he has participated in more than three dozen arbitrations in Portugal, since 2000. Francisco also teaches on a post-graduate course on Arbitration. The 2014 and 2015 editions of the "Client Choice Awards" recognized Francisco as the best lawyer in Portugal in litigation.

Bio

Sofia Vaz Sampaio

Senior Associate at Morais Leitão, Galvão Teles, Soares da Silva e Associados

Email: sofiasampaio@mlgts.pt
Tel: +351 210 091 738
Sofia Vaz Sampaio is a member of the litigation and arbitration team. Sofia has acted as counsel in several judicial and arbitration proceedings, domestic and international, in a variety of industrial sectors, such as banking, construction, food and beverage, infrastructures, media and advertising, public-private partnerships, energy, and telecommunications. In 2011 Sofia practiced law as foreign intern at Skadden, Arps, Slate,

Latest Digital Issue