and conditions and the adequacy of the counterparties acting as risk carriers. It is in the interests of both the insureds and the lenders to ensure that, if a claim is to be made there will be no uncertainty regarding whether the insurers will deny liability for a portion or all the loss citing the existence of another insurance that may be brought into contribution for its rateable proportion. The 'other' insurance may be poorly constructed and entered into with a less creditworthy insurance counterparty. At best, the project company would be faced with delays in receiving loss proceeds due to the need to progress the claim and agree liability and quantum with another set of insurers and at worst, it could find that a portion of the loss lies with an entity lacking the financial strength to pay. Therefore, this clause is intended to maintain the integrity of the intention between the insured and the insurer to have the designated insurance cover in place.

6.72 To establish whether contribution will apply, it is necessary to establish whether or not the following factors exist between the policies. First, do they cover the same subject matter? A policy covering the buildings and a policy covering both the buildings and their contents would contribute in the event of damage to the buildings but not the contents. Secondly, do they cover the same peril causing the loss? This must be the same under both policies meaning that a policy covering property on a fire and perils basis would not contribute with a policy covering theft only, whereas a policy covering 'all risks' will contribute with a fire policy. Thirdly, are they both policies of indemnity? Contribution only applies to contracts of indemnity and not to contracts that provide benefits. Fourthly, do they both cover the same insurable interest? Different persons can have an interest in the same property, for example, a senior lender and a project company, a landlord and a tenant, a mortgagor and a mortgagee. If each takes out insurance to protect their own interest there will not be contribution. However, if both insure their own interest but one includes the interest of the other party then there will be contribution with respect to the overlapping cover. Finally, do they both provide liability for the claim? Both policies must establish that the claim is covered by its terms and conditions and therefore is liable to pay the loss. If one policy has more strict terms that mean the relevant insurer is not liable, then it will not contribute to the loss.

Subrogation

6.73 Sometimes the insured event is the responsibility of another party. This could have two undesirable consequences: first, the insured could claim under their policy, then pursue the guilty party and so recover more than they had lost, which would breach the principle of indemnity.[35] Secondly, the insured who suffered the loss and is indemnified by insurers may suffer a further loss because the cost of maintaining

[35] MacGillivray, 22-2. An insurer may not avoid liability on the grounds that the insured has a right of action against a third party just as a third party may not avoid liability to the insured based on the existence of insurance covering the loss suffered.

its insurance coverage (for instance, at the renewal of the policy) will have increased to reflect the loss experienced by the insured. To prevent these situations from occurring, the courts have developed the principle of subrogation. This allows insurers to recover their outlay for claims settled under a contract of indemnity from the third party in the name of the insured and this also ensures that the premiums of the insured will not rise.

6.74 Under English law, there are four ways in which the rights of subrogation may arise. The first is in tort, and most commonly subrogation arises after an insured loss is caused by a negligent third party who remains liable for the loss caused. Because the damages are also insured, the insurers can recover what they pay out from the negligent party. Subrogation may also arise by way of contract, meaning that if a contractual term makes another party responsible for the damage which has been sustained, then the insurers can recover the amount they pay out in the event of a claim. Thirdly, under statues like the Riot (Damages) Act 1886 the police are responsible for keeping the peace as well as for damage caused by rioters if they fail to do so. Fourthly, where a constructive total loss has been paid by an insurer the insurer becomes the owner of the undamaged property and can raise funds by selling it. Insurers can only recover their liability under the insurance contract. Therefore, if the claim has been settled with reductions because of, for example, an excess applying, the insured can still recover this uninsured amount from the party responsible.

6.75 When subrogated to the rights of the insured, the insurer has both a right of action in money against the third party that caused the loss, as well as an equitable proprietary interest in any money received by the insured from that third party as compensation. An insurer who has paid under the insurance therefore benefits from all rights possessed by the insured relative to the loss insured against.[36] In the event the insured receives compensation both from the insurer and from the third party who caused the insured loss, and the total amount of compensation exceeds the quantum of the insured loss, the insured must account to the insurer for any excess amount.[37]

Mitigation of the risks presented by general insurance law principles—lender endorsements

Lenders as insured parties and severability of interest

6.76 By being a named insured, the lenders obtain a degree of control over the relevant insurance policy. It provides protection to the lenders in their own right against any

[36] Chitty, 41-091, citing *Castellain v Preston* (1883) 11 QBD 380; *Lord Napier and Ettrick v Hunter* [1993] 2 WLR 42; Marine Insurance Act 1906, s 79.

[37] Chitty 41-094.

liabilities that may arise from their activities related to the project as well as allowing them to bring claims in respect of their own insurable interest.

6.77 By insuring their interest it means that there is a 'severability' of insurable interest that facilitates protection in the event another insured voids the policy. For example, if the project company voided a policy in a situation where the lenders were not also a named insured, cover would be withdrawn as there was only one insured involved and no other insurable interest that could be indemnified. There would therefore be no protection of the project company's ability to maintain its debt service obligations in situations where insurance acts as the sole source of revenue protection, for example, following a natural *force majeure* event.

6.78 With insured party status, the lenders may exercise their rights over the policy, particularly in a 'step in' situation whereby they would need not only to take possession of the policy in order to control its benefits, control premiums, return of premiums, and negotiation of claims, but also to protect themselves against any liabilities or risks that arise following the taking over of the project assets, as well as prevent the cancellation of the insurances by the insurers following the demise of the project company. Customarily, the lenders are named as additional insureds on all material insurance policies of the project company except with respect to the employer's liability and motor vehicle liability insurances.

Vitiation and invalidation

6.79 'Non invalidation' and 'non vitiation' are generally used as synonymous terms. An invalidating or vitiating act occurs where an insured fails to make a proper disclosure of material information to the insurers or otherwise misleads them by way of a misrepresentation, whether innocent or deliberate. This would entitle the insurers to declare the policy void or give them grounds to vitiate a given contract of insurance. Similarly, if an insured breaches a term, condition, or warranty contained in a contract of insurance, the insurer is entitled to invalidate cover with respect to the loss.

6.80 Under English law, where the insurance has more than one insured party and also includes a severability of interest clause, insurers will accept liability for losses where one insured party has been at fault for breaching policy terms and conditions. The protection obtained by the 'non invalidation' wording is that insurers will not declare the policy void with respect to the other insured parties who have not made a false disclosure or breached any term or condition of the contract of insurance. Therefore, the position of the other insured parties is always protected, provided they themselves do not fail to make a material disclosure to insurers or otherwise mislead the insurers or breach a condition or warranty of the insurance.

6.81 The purpose of the 'non-vitiation clause' or 'non invalidation clause' in a project financing is to prevent the insurer from using such a vitiating event as a means of declaring the contract of insurance to be void and thus circumventing its obligation

to make payment to the lenders as loss payees. To ensure the optimum level of protection, the project company needs to be protected in the insurance policies by:

(1) a provision that expressly sets out that each insured party operates as a separate and distinct entity and cover applies in the same manner and to the same extent as if individual policies had been issued to each insured party in respect of its own interest;
(2) a provision that clearly states the liability of the insurers to any one insured is not conditional on the due observance or fulfilment by any other insured party of the terms and conditions of the policy or duties imposed; and
(3) an express 'non invalidation' insurance protection in the insurance policies that states a vitiating act committed by one insured party shall not prejudice the right to indemnity of any other insured party.

6.82 A further issue with respect to such clauses in project financed transactions centres, not on the invalidating act itself, but rather on the insurers' right to subrogate to the rights and remedies available to the party they indemnify, against any party that was responsible for an invalidating act that contributed to the loss for which the insurance indemnity was made. There are two aspects to this:

(1) First, if a lender is found to have committed an invalidating act that in some measure contributed to the amount of indemnity payable under the insurance programme to another project party, the insurers seeking to recover from them to the extent of the lender's culpability should not expose them to a right of action. Not surprisingly, insurers can be very resistant to waiving rights against a party that is culpable of a vitiating act. In practice, it is highly unlikely that a lender will ever be in a position to invalidate the insurance and therefore the risk to the lenders in not obtaining this 'protection' is not considered significant. It is fairly standard (although not universal) for insurers to retain rights against the party that vitiates. However, insurers will also often agree to waive rights of subrogation in favour of the lenders in this regard.
(2) Secondly, the insurers should not as a rule have the ability to assume the rights of the lenders under the finance documents against the project company. Insurers, when requested, commonly agree to this. Therefore, if the insurers pay a claim to the lenders in circumstances where the project company may have committed a vitiating act, the insurers would not then be able to seek recovery of their outlay to the lenders by pursuing the project company using the lenders' rights under the financing documents.

Assignment of insurances

6.83 In project finance transactions, the key element that is used to create security for the lenders in the insurance programme is a legal assignment of the insurance. The project company will issue a notice of assignment in respect of the marine transit, construction, physical damage, delay in start-up, operational physical damage, and

business interruption, and other material policies of insurance and reinsurance and acknowledgements of such assignments are customarily obtained.

6.84 It is crucial to the lenders' ability to rely on and take security over the insurance programme that the project company assigns to the security agent or trustee all its rights, title, benefits, interests, and claims, whether existing now or in the future, under and in respect of the material insurances (the insurer will do likewise in respect of the reinsurances) and all insurance proceeds in respect of material insurances and reinsurances. The assignment will not include any material insurance in respect of liabilities to third parties to the extent that the assignment of that right, title, benefit, interest, or claim is unlawful or impossible as a matter of law, or would constitute a breach of the terms of any contract or agreement regulating or creating such right, title, benefit, interest, or claim. Additionally, the assignment will have to be structured to ensure that it will not render the insurance or reinsurance contract void or voidable or unenforceable by the project company or any other insured or reinsured party as a result of the deed of assignment. Finally, assignment is not typically required with respect to the non-material insurance such as employers' liability or motor vehicle liability insurance. In the event that the lenders exercise step-in rights these insurances would need to be effected in respect of the substitute company's directors, employees, and motor vehicles.

6.85 One of the key differences between New York and English law-governed financings relates to the manner in which security is taken over the project insurances. Unlike in England, assignments of insurances or reinsurances are rarely used in financings governed by New York law. Rather, security is granted by way of a pledge and security agreement that serves to attach the policy of insurance and, under the New York Uniform Commercial Code, art. 9-203, also provides for the perfection of the security interest. This will often be complemented by a separate acknowledgement or endorsements whereby the insurer agrees that proceeds are to be paid into project accounts over which the lenders have security.

Loss payee provisions

6.86 Under the finance documents, the project company is typically required to open and maintain an insurance and compensation account for receipt of insurance proceeds (other than delay in start-up, business interruption, and/or third party liability proceeds) and other compensation amounts. The insurance policies will contain loss payee provisions that treat the project company as the sole loss payee but will direct that proceeds be credited to different accounts depending on their nature. Material damage insurance proceeds (all proceeds of insurance received by or payable to the project company under the 'material damage' policies of marine transit, CEAR, and PD insurance) and third party liability proceeds (not paid directly to third parties) will be credited to a compensation account along with any other compensation amounts that are not expressly directed elsewhere. Proceeds from loss of revenue insurance (including proceeds received in respect of a delay in

start up) will be credited to the project company's offshore operating or revenue account. Any proceeds payable directly to a third party in settlement of third party liabilities will be paid directly to the third party claimant unless the payment is to indemnify a payment already made by the project company, in which case those funds will be paid into the insurance account. The lenders are granted security over the project company's accounts and any disbursements to be made from those accounts are regulated by the provisions of the finance documents. Typically, the notices of acknowledgement of the reinsurance assignment contain loss payee provisions that direct the reinsurers to pay insurance proceeds directly to the project company's accounts.

Waiver of rights of subrogation

6.87 In the context of a project financing, policies of insurance will frequently cover multiple parties. These parties, in the event a loss occurs, could have valid claims against one another and the insurer might be entitled to subrogate itself to these rights. For instance, if the project company and a subcontractor are both insured parties under the same policy, any loss caused by one to the other could result in the insurer subrogating itself to the rights of the injured party against the party that caused the loss. To avoid the numerous problems that this would pose, the insured would typically insist on the inclusion of a waiver of rights of subrogation in which the insurer waives any right of subrogation it has against certain defined parties. While the parties against which this right is waived might be explicitly named, in other circumstances a group may be defined generally to include, for example, all subcontractors or the secured lenders.

Ability to amend insurances and market availability

6.88 Since risk is variable, the initial insurance may cease adequately to cover the project and the lenders. For this reason, the finance documents may allow the lenders' agent or trustee, acting reasonably or on the instructions of the majority lenders and in consultation with the lenders' insurance advice, to require that the project company seek an amendment to an existing policy within a given time period.

6.89 Like many markets, the insurance market is subject to cyclical movements and changes in risk appetite. As a result, an insurance programme agreed between the project company and the lenders at financial closing which reflects the availability and terms of insurance available at that time may not be deliverable by the project company throughout the term of the loans. Certain types of cover may become unavailable (as was the case with terrorism insurance in the immediate aftermath of the events of September 2001). More commonly though, some specified insurances may cease to be available on 'commercially reasonable terms', such that a prudent company would not consider it appropriate (based on a reasonable risk-reward balance) to place such insurance. Alternatively, certain deductible levels or endorsements required by the lenders may cease to be available or insurers may

decline to provide such endorsements containing the required wording. In such instances, it is not unusual for the finance documents to contain a mechanism to allow for a suspension or amendment of the relevant insurance obligations until such time as the project company is able to resume such obligations.

Broker's letter of undertaking

Purpose

6.90 The role of an insurance broker is to act as an intermediary between the insured and the insurer or, in the context of reinsurance, between the insurer and the reinsurer. It thus becomes necessary that material information passes from the broker to both parties to ensure that a valid contract of insurance is formed. In the case of primary insurances, the broker acts as the agent of the project company and so the lenders typically wish to ensure they can control the scope of the grant of authority that the broker receives from the project company and commit the broker to act appropriately. This is done by way of a broker's letter of undertaking (often referred to as a BLOU) which is included in the schedule of insurances set forth in the finance documents. It is signed by the broker and addressed, as appropriate, to the onshore or offshore security agent or trustee.

Customary provisions

6.91 The provisions included in a BLOU vary significantly depending on the nature of the project as well as the state of the insurance market. Generally, it will require that the broker provide material information to the project company and the lenders and contain provisions ensuring that payments be made to specified project accounts. The broker will also confirm that the insurances entered into are in full force and effect and are substantially in form required by the relevant finance documents and the schedule of insurances. As is crucial to ensure the validity of the insurances, the BLOU will also confirm that the broker made adequate disclosure to insurers and reinsurers and that no such disclosure was inaccurate, incomplete, or misleading.

6.92 The BLOU will often include specific undertakings to give notice to the lenders that any insurance to be entered into, renewed, or renegotiated will comply with the requirements of the relevant finance documents. The broker will also undertake to give similar notice in the event premiums due are not paid and that all premiums received from the project company will be appropriately paid to, as relevant, the insurers or reinsurers. Information regarding any act, omission, or event that any insurer or reinsurer advises may have a material impact on the cover provided by the project's insurances will need to be notified to the lenders. Any change to the insurances that the lenders require be put in place will also need to be notified. In particular, this includes notice of any assignment or purported assignment or the creation of any security interest over any of the insurances. Since the insurance

market is not static, changes to the terms of insurance or reinsurance may be necessary and the broker will be obliged to give notice of any alteration of material terms of insurance or reinsurance, including changes to any premiums that are payable, as well as the expiry of coverage. Of course, notice must also be given if the broker ceases to act in that capacity.

Broker's letter of undertaking in the context of reinsurance

6.93 As mentioned previously, because certain jurisdictions require that insurance be purchased in the domestic insurance market, and because of the scope and nature of the risk being insured in an international project finance context, a certain percentage of the insurance is required by the lenders to be reinsured. The crucial difference in respect of the broker, in the context of reinsurance, is that it is acting as an intermediary between the primary insurer and reinsurer. As such, it has no obligation to the insured parties or the lenders in much the same way the primary insurance broker would not normally have an obligation towards the lenders. Otherwise the BLOU serves much the same function as under the primary insurances, and must be executed by any broker acting as agent of the insurers.

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PRINCIPAL LOAN FINANCE DOCUMENTATION

Gabriel Mpubani, Milbank, Tweed, Hadley & McCloy LLP

Introduction 7.01
Credit Agreements 7.03
Purpose clause 7.06
Conditions precedent 7.07
Drawdown of loans 7.12
Repayments 7.15
Prepayments and cancellation 7.17
Interest 7.23
Market disruption 7.26
Yield protection 7.28
Tax gross up 7.31
Increased costs 7.34
Representations and warranties 7.35
Covenants 7.37
Financial ratios 7.40
Events of default 7.47
Remedies 7.50
Accounts Agreements 7.52
Shareholder Senior Facilities 7.58
Mezzanine Facility Agreements 7.59
Introduction 7.59
Key features of mezzanine facility agreements 7.63
Selected mezzanine facility agreement issues 7.68
Subordinated and Equity Bridge Facility Agreements 7.69
ECA Covered Facilities 7.77
Documentation 7.78
Eligibility criteria 7.80
Bribery and corruption—OECD Guidelines 7.81
Policing environmental covenants 7.83
Other documentation issues of interest to ECAs 7.92
Intercreditor Agreements 7.101
Introduction 7.101
Drafting and negotiation considerations 7.105
The typical project finance creditor classes 7.109
Selected intercreditor issues 7.112
Considerations affecting hedge providers 7.129
ECA covered loan voting mechanics 7.133
Considerations affecting project bonds 7.135

Introduction

7.01 Project financings can be document-heavy transactions due to the elaborate risk allocation and mitigation measures they engender. A particularly complex financing will generate copious amounts of documentation addressing the project's construction and operation, the financing that supports it, and the security that in turn underpins the financing. The financing arrangements between the project

company and the lenders will typically be memorialized in a suite of documents that reflect the idiosyncrasies of the particular transaction. Needless to say, great care must be taken faithfully to reflect the parties' actual commercial bargain; the consequences for not doing so are considerable.[1]

7.02 This chapter will analyse the key loan documentation typically encountered in a project financing and a selection of the key documentation issues therein that most often arise in practice.

Credit Agreements

7.03 The credit agreement is the principal legal document that formally records the express terms[2] agreed by the borrower and lender to govern their contractual relationship. At its core, the lender will lend or agree to lend a sum of money to the borrower in return for the borrower's promise to repay that sum either on demand or at the agreed time, usually with interest.[3] This foundation will be supplemented by protective and administrative provisions, such as representations and warranties, covenants, events of default, agency mechanics, and dispute resolution clauses, among others. Market practice and the desire on the part of arrangers and originating lenders to syndicate or sell down all or part of the loan will often dictate the form, if not the substance, of the credit agreement. Potential syndicatees and transferees will baulk at participating in agreements that contain material provisions seen to be unusual or 'off market'. There is therefore merit in reserving adventurous or novel ideas for the genuinely bespoke and complex transaction. For this reason, a number of English law governed project finance credit agreements are based on the London Loan Market Association's (LMA's) leveraged form credit agreement, duly adapted to suit the relevant circumstances of the particular transaction, and are readily recognisable in the lending market.

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[1] This is particularly important under English law, where pre-contractual negotiations will, as a general rule, be superseded by the written agreement of the parties. But not, it appears, under continental civil law regimes. Art. 4.3 of the UNIDROIT Principles of International Commercial Contracts, UNIDROIT, 2004 and Art. 5.102(a) of the Principles of European Contract Law (1999) allow recourse to prior negotiations in ascertaining the 'common intention of the parties', as does the United Nations Convention on Contracts for the International Sale of Goods (1980). See also C. Valcke, 'On Comparing French and English Contract Law: Insights from Social Contract Theory', 16 January 2009 at <http://ssrn.com/abstract=1328923>, mentioned favourably by Lord Hoffmann in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, which case also reviews the English case law authorities on the point.

[2] In addition to other terms that may be implied by the applicable general law.

[3] Certain jurisdictions, such as Saudi Arabia, do not enforce the payment of interest on the basis that it is contrary to *Sharia'a* law. In those cases, other fee or profit-sharing structures may be employed. These are more fully explored in Chapter 10.

7.04 In a multi-sourced financing where a number of lenders are advancing different tranches of debt, it has become customary for the provisions that are common to the various debt tranches to be set out in a 'common terms agreement'. This allows the commercial and operational features unique to each debt tranche to be set out in a more streamlined agreement, which incorporates the common terms by reference. This approach saves time and cost in avoiding multiple bilateral negotiations over substantially similar provisions, ensures lender parity, at least to the extent of the common terms, and, perhaps most importantly, reduces the risk of terms being construed inconsistently across tranches, particularly where they are governed by different laws.

7.05 The project financing credit agreement is broadly similar to the agreement seen in other financings, with a few (but critical) differences, some of which are explored below. Detailed checklists of the typical conditions precedent, representations and warranties, covenants, and events of default customarily set out in project financing credit agreements are outlined in Appendix 1.

Purpose clause

7.06 Most credit agreements will set out the purpose for which loans advanced under the agreement are to be applied. Lenders will want to ensure that the borrower does not divert the borrowings away from the project and to demonstrate compliance with their lending eligibility criteria. In most cases, actual misuse will trigger an event of default. Furthermore, the purpose clause evidences the intention of the parties in advancing the money, which helps protect the lender on the borrower's insolvency if the money has either not yet been applied or has been misapplied. Under English law, a loan to a borrower for a specific purpose, where the borrower is not free to apply the money for any other purpose, gives rise to fiduciary obligations on the part of the borrower which a court of equity will enforce.[4] When the money is advanced, the lender acquires an enforceable right in equity, rather than in contract, to prevent its application for any other purpose.[5] This prevents the borrower from obtaining any beneficial interest in the money while the designated purpose is still capable of being carried out. If for any reason the purpose cannot be carried out, for instance, on abandonment of the project, a resulting trust would prevent the money from falling within the general fund of the borrower's assets so as to pass to its trustee-in-bankruptcy in the event of its insolvency; the money would not become part of the assets of the borrower.[6]

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[4] Per Lord Millet in *Twinsectra Ltd v Yardley* [2002] 1 AC 384.

[5] Most credit agreements will state that the lenders are not obliged to monitor the application of the funds, thus making clear that the equitable right is not burdened with a policing obligation.

[6] See *Quistclose Investments Ltd v Rolls Razor Ltd* [1970] AC 567; *Twinsectra Ltd v Yardley* [2002] 1 AC 384.

Conditions precedent

7.07 Upon signing the credit agreement, the lenders become committed[7] to lend the agreed sums of money to the borrower, subject to the conditions specified in the agreement itself. There will usually be two sets of conditions precedent: those which are common to all debt tranches and are therefore set out in the common terms agreement; and those which are specific to a particular debt tranche and are therefore set out in the individual loan agreement applicable to that tranche. Each set of conditions precedent will usually be divided into two parts: one being those conditions precedent that apply only to the initial drawdown of loans and the other applying to both the initial and subsequent drawdowns.

7.08 Conditions precedent to the initial drawdown are designed to ensure that:

(1) the borrower is duly authorized to borrow the loans and grant the relevant security;
(2) the project has satisfied the lenders' due diligence requirements and verification by their advisers;
(3) the project complies with applicable laws and governmental permits;
(4) all material project and finance documents have been entered into and are binding and enforceable against the parties thereto; and
(5) the security arrangements are adequate and effective.

7.09 Conditions precedent to each subsequent drawdown are designed to ensure that there is no material deterioration in the risk profile of the project or the borrower and that the lenders do not lend into a distressed project on terms designed for benign conditions. Thus, these conditions precedent will help the lenders to:

(1) ensure that agreed construction milestones are being met as scheduled and on budget;
(2) identify emerging problems such as environmental or technical complications; and
(3) confirm that no other material adverse events have arisen since the last drawdown.

Loan drawdowns are often directly tied to progress under the construction contract, and many credit agreements may require a technical adviser's certification that certain 'milestones' have been achieved or that a prescribed degree of construction has been completed.

[7] However, under English law, an order for specific performance would not be available to compel the lender to honour its obligation to lend under a loan contract nor will the borrower be able to maintain a debt claim for the unadvanced moneys; the borrower would only be entitled to damages for its actual loss caused by the lender's non-performance, which may, depending upon the circumstances, be minimal. See *South African Territories v Wallington* [1898] AC 309.

7.10 Usually, the initial conditions precedent will have to be met to the satisfaction of, or waived by, each lender while subsequent conditions precedent (other than those in respect of which a particular lender may insist on a veto right[8]) will commonly only be fulfilled to the satisfaction of a prescribed majority of the lenders. This means that a single lender could prevent an entire syndicate from making the initial (and perhaps even subsequent) advances of the financing. Some borrowers attempt to secure the lenders' prior agreement on the form and content of as many of the documentary conditions precedent as possible prior to signing the credit agreement, but this is often resisted as lenders do not want to commit the required resources until they have firm assurances that they will definitely participate in the financing and have completed their due diligence. Neither the lenders' agent nor counsel will be willing to certify unequivocally that the conditions precedent comply with the terms of the credit agreement. However, it is not uncommon for a letter to be furnished by one of them to the lenders stating that documents have been provided by the borrower which appear to comply with the required conditions precedent.

7.11 Where ECAs are either guaranteeing or directly providing 'tied' lending to a project, there will be additional conditions precedent requiring the borrower to deliver documentation evidencing the eligibility of the costs being funded. Such documentation would typically include the relevant goods or services supply contracts to which the funding is tied; documents certifying the eligibility of the goods or services, together with supporting documentation, such as bills of lading and certificates of origin; and, where funding is being made available on a reimbursement basis, certification that the relevant invoices in respect of the eligible goods or services have been paid.

Drawdown of loans

7.12 If the conditions precedent have been met, the project company will be entitled to request loans to be advanced to it by delivering written requests in accordance with the procedures set out in the credit agreement. The loans may be drawn in their entirety at once or in installments during the availability period. Lenders always require a minimum period of notice to raise the funds in the interbank market. This notice period is negotiated, but will largely be driven by the customary practice of the relevant interbank market. However, such notice period should be sufficient to allow a reasonable time for the lenders' agent to fulfill its obligations and enable the lenders to take the necessary steps to fund before any proposed date of drawdown. Development finance institutions (DFIs), micro finance institutions (MFIs), and export credit agencies (ECAs), usually require longer notice periods, particularly where the loan is to be disbursed in a currency other than dollars, euro, or sterling.

[8] For instance, in relation to compliance with its environmental standards or, in the case of an ECA, its official credits eligibility criteria.

7.13 A drawdown notice will usually be stated to be irrevocable and the borrower is typically liable to pay the lender's breakage costs if it does not proceed with a borrowing after delivering a drawdown notice. However, whereas the borrower may not withdraw from the drawdown without penalty, lenders will typically be entitled to stop an advance at any point prior to wiring the funds, if they became aware of a 'draw-stop' event, typically a default or other occurrence such as supervening illegality or market disruption, entitling the lender to withhold funding.

7.14 In a multi-sourced financing, the borrower will usually request that funding be made through a single lenders' agent for logistical convenience, a practice which, albeit normally accepted, exposes the lenders to a risk of the agent's insolvency for the duration that the disbursed loans are in the agent's possession.

Repayments

7.15 Project finance loans typically have long tenors to reflect the credit profile of the relevant project, with the loan amortizing over time. The repayment profile of a project finance loan will usually reflect the revenue generating characteristics of the relevant sector; thus, where revenues are cyclical and volatile, the credit agreement could allow the borrower to defer principal repayments during the lean cycles and then 'catch-up' with the repayment schedule when the project's revenues permit. Sculpted repayment profiles are increasingly common, but will only be agreed where the business case is clearly made. Also, where the project generates excess cash in certain periods, the lenders may require that all or part of the surplus is applied to make prepayments, thereby reducing the average life of the loan.

7.16 Repayments will usually be made to the lenders' agent for distribution to the lenders, usually on a pro rata basis. As a function of the law of agency, the borrower's obligation to pay is, as a general rule, discharged upon paying the agent even if the agent then fails to pay the lenders.

Prepayments and cancellation

7.17 Most credit agreements will expressly permit the borrower to repay all or part of the loan early. It is widely thought that no such right can exist in the absence of an express prepayment clause. Prepayment can be either mandatory, upon the occurrence of certain prescribed events (for example, illegality, change of control, or damage to the plant), or at the borrower's volition.

7.18 Voluntary prepayment will usually be conditional on the borrower giving the lenders a minimum amount of notice and prepayment being made at the end of an interest period. If the borrower requests the right to prepay other than at the end of an interest period, it will usually be granted on the basis that the break costs indemnity is applicable and that any costs of unwinding interest rate hedges are for its account.

7.19 Some lenders occasionally request a prepayment fee or premium on the basis that they have incurred costs and agreed margins on the expectation of a return over a longer period. Borrowers maintain that the flexibility to make prepayments is central to the efficient management of a project's finance plan and will, if relevant, point to prepayment as being a key justification for preferring bank loans over a less flexible capital markets debt issuance. However, borrowers also recognize that certain DFIs, MFIs, and ECAs are required by their internal policies to demand a prepayment premium upon a voluntary prepayment.

7.20 Prepayments can either be applied rateably to reduce all scheduled repayments or chronologically to reduce the earliest scheduled repayments. Lenders prefer prepayments to be made rateably in inverse chronological order (i.e. the latest scheduled payments being prepaid first) to shorten the average life of the loan and avoid effectively giving the borrower a repayment holiday.

7.21 Prepayments or cancellations of commitments proposed to be made during the availability period will usually be an indication of 'over-borrowing'. However, lenders will customarily insist on a certification that there will be sufficient committed funding after the prepayment or cancellation to complete the project without the borrower having to incur additional debt.

7.22 There are a number of events, most of them outside of the direct control of the borrower, which will, upon their occurrence, trigger an obligation enjoining the borrower to mandatorily prepay the outstanding loans. These typically include:

(1) Illegality, although the borrower will usually have the option of requesting the affected lender to sell its participation to another unaffected lender, switch the location of its lending office to the extent possible, or allow a grace period within which to make the prepayment, being the maximum period permitted by applicable law.
(2) Change of control, usually to guard against unsavoury or inexperienced sponsors taking over the project; this obligation will sometimes fall away after a prescribed minimum retention period, but will usually only be contemplated if the sponsor has no material obligations to the project.
(3) Deterioration of the borrower's credit rating below a prescribed level, particularly in relation to rated project bonds, where certain lenders are prevented by internal policy from lending other than to an investment grade credit.
(4) Recoveries, such as insurance and compensation realizations for damage or loss to the project above a specified threshold, or liquidated damages paid under the construction contracts.
(5) Failure to meet prescribed financial ratios, including those which form part of a completion test.
(6) The realization of excess cash, in which case the lenders may wish to share all or part of it to shorten the loan life.

Interest

7.23 Most credit agreements not structured as Islamic financings[9] will charge interest on the loans advanced to the borrower, either on a floating or a fixed rate basis. Floating rate lending is based on the notion that lenders fund their loan participations through short-term deposits in the interbank market for each interest period at an interbank rate usually provided through a screen service such as Telerate or Reuters. If a screen rate is not available, an arithmetic mean of rates quoted to the lenders' agent by pre-named reference banks will be used instead. The rate will therefore reflect the lender's cost of funds, and a margin, the latter being the lender's return for accepting the borrower's credit risk. This will be in addition to other fees charged on the loan.

7.24 During the construction period, a project will not be revenue generating. As such, interest will either be paid from debt drawdowns (for which reason financing costs will be included in the definition of project costs) or will be capitalized and added to the principal amount.

7.25 A failure to pay interest when due will trigger a payment default but also cause a higher, default rate to apply, usually in the range of 100 to 300 basis points.

Market disruption

7.26 Most credit agreements recognize that LIBOR or the relevant interbank offer rate may not accurately reflect a lender's funding cost and consequently will contain a so-called 'market disruption clause' to protect lenders accordingly. A minimum threshold of lenders will usually be required to trigger this clause,[10] to rule out disruption that is unique to a few lenders, rather than being truly reflective of the state of the market. If the market disruption clause is triggered, each lender would be paid interest at a rate calculated by reference to that lender's cost of funding its participation in the loan from whatever source it may reasonably select.[11]

7.27 Despite its ubiquity in credit agreements, the market disruption clause will only be invoked very rarely as demonstrated in the recent 'credit crunch' when LIBOR was severely criticized but abandoned in only a relatively small number of cases. Reasons for this reticence are manifold: lenders are reluctant to be seen to have higher than average funding costs as it is a reflection on how the market perceives their credit risk. Also, some banks are unwilling to disclose their cost of funds for competitive and reputational reasons and will absorb the mismatch rather than disclose their

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[9] In respect of which see Chapter 10.

[10] In the London market, the required threshold is typically a simple majority or 35 per cent, while the US market tends to retain the same percentage that would apply to normal amendments and waivers under the credit agreement, typically 66.67 per cent.

[11] In the US market, the interest rate would begin to be calculated by reference to the 'base rate', a domestic US pricing option that historically has often exceeded US dollar LIBOR.

internal calculations. Thus, the continuing importance of this clause is in practice limited to those relatively rare circumstances where loans are being advanced in less convertible currencies.

Yield protection

7.28 Credit agreements will invariably set out a cluster of provisions intended to safeguard the yield that the lenders expect to receive from lending to the borrower.

7.29 The borrower will be required to preserve the lenders' profit margin from tax impositions and the mandatory costs arising from changes in law or compliance with the requirements of a central bank or other monetary authority, generally regardless of whether or not the occurrence existed on signing the credit agreement.

7.30 In most cases, if the borrower becomes obliged to make a yield protection payment, it may elect to prepay the affected lender's loans instead, an exception to the equal treatment paradigm that underpins most credit agreements. Lenders are also usually under an obligation to take reasonable mitigation measures, including transferring their loans to an affiliate or other lending office. Also, assignments and transfers by lenders must not increase the borrower's obligations to protect the lenders' yield.

Tax gross up

7.31 Lenders very rarely agree to take withholding tax risk, and as such, the inclusion of a tax gross-up clause is usually a non-negotiable prerequisite. The gross-up clause will shield lenders from the effects of withholding taxes on interest payments by requiring the borrower to make payments in full as if there had been no deduction; it usually takes no account of the ability on the lender's part, to obtain tax credits for the deduction in due course, as this would in itself impose a time and administrative cost and expose the lender's tax affairs to potential scrutiny by the borrower. Where the financing structure features an A/B loan structure,[12] the tax gross up may be extended to deductions on payments to the B loan participants.

7.32 Borrowers will also be required to indemnify the lenders against any tax (other than normal profit tax) imposed on or in relation to sums received under the credit agreement. The indemnity will not, however, extend to taxes on net income imposed by the lender's jurisdiction of incorporation or residence or the location of its lending office.

[12] See para. 8.35 et seq.

7.33 In cross-border transactions, the laws of the borrower's jurisdiction of incorporation, and those of other jurisdictions through which payments are made, are relevant, and local counsel should, as a matter of good practice, be consulted.

Increased costs

7.34 The increased costs clause is designed to protect lenders against changes in law or official regulation that increase their underlying costs, such as those deriving from central bank reserve, capital adequacy, and liquidity requirements and will customarily feature in domestic or eurocurrency loans. The increased costs clause usually excludes existing requirements or costs caused by a lender's willful non-compliance with relevant regulations.

Representations and warranties

7.35 A lot of time is spent negotiating representations and warranties, which in project financings, are extensive and are repeated often. The set of representations and warranties will typically be based on market standard forms such as the LMA leveraged form, with additional representations added to reflect the policy requirements of certain lenders, such as ECAs and DFIs, as well as the specific characteristics of the borrower and the project. Appendix 1 sets out a list of representations and warranties typically encountered in project finance transactions.

7.36 Borrowers will seek to restrict the scope of representations and warranties, particularly by using materiality or knowledge qualifications in respect of commercial warranties. Each representation and warranty will be deemed to be made on the date of signing the credit agreement. Selected representations and warranties will be deemed to be repeated at important stages, including on financial close, the first and each subsequent drawdown (if different) and in some financings, at the beginning of each interest period.

Covenants

7.37 The project finance covenant package is one of the broadest in the financing world, extending beyond the borrower to include the sponsors and other counterparties to material project contracts whilst they owe obligations to the project (most often during the construction period, but also, for example, in the case of product off-take, during the operating period). Due to the limited or non-recourse nature of the credit, the project lender's basic instinct is to assert a far-reaching control over the project and its revenue-generating capacity, recognizing that the debt advanced by it will be recoverable from that source alone. In negotiating the covenant package, the lenders will therefore, as a starting point, discount the strength of the sponsor as there may be little to prevent the latter from walking away from the project. Naturally, the sponsors will seek as light a covenant package as they can credibly make a case for, largely arguing that an overly strict covenants package interferes

with their ability to run the project profitably. A balancing act is therefore inevitable, and the lenders will draw on the advice of their various advisers in finding the appropriate equilibrium.

7.38 The negotiation surrounding the covenant package will, in many cases, be driven by precedent. Many an adviser is at a loss to explain the rationale for a particular provision beyond it having featured in a transaction that was successfully financed. Barring such instances where precedents become an article of faith, there are sound reasons for a full complement of covenants in the typical project financing: information covenants will provide data to evaluate the ongoing soundness of the project; financial covenants will serve as early warning signs of the project's inability to service its debt obligations; negative undertakings will ensure that the borrower does nothing to materially undermine its creditworthiness and the project's risk profile, while positive undertakings will require the borrower proactively to maintain or enhance its credit. At this basic level, project financing is no different to any other financing. It is in the detail of the various covenants, however, that the project financing loan makes a firm departure from the corporate or leveraged buy-out loan.

7.39 The reader is referred to Appendix 1 for a checklist of the typical covenants which are customarily found in a project financing credit agreement.

Financial ratios

7.40 Project financings, like most other leveraged financings, invariably feature financial ratios which will not only frequently test the lawyers' patience but also, on an ongoing basis, the debt capacity of the project and its ability to generate revenue in amounts that are sufficient to meet its operating costs and repay the debt on a current basis. The types of ratios used will vary depending on the project and its sensitivities, but certain ratios have become almost standard in the typical limited recourse financing. These are: (1) the debt to equity ratio; (2) the backward-looking DSCR;[13] (3) the forward-looking DSCR; and (4) the LLCR.[14] In mining projects, a reserve tail ratio will also be relatively common.

7.41 The debt to equity ratio is a snap shot test to assess the dependence of a project on debt. Customarily, a cap will be imposed on the leverage of a project, usually ranging from 50 per cent to 80 per cent, depending on a number of factors ranging from common sector benchmarks to the revenue profile of the project company. The DSCR and LLCR seek to test the ability of the project company's cashflows adequately to cover its debt service obligations. The backward-looking DSCR is calculated on the basis of the project company's actual performance, usually

[13] Debt service cover ratio.
[14] Loan life cover ratio.

over a prior twelve-month period; the forward-looking DSCR and LLCR are based on projected revenues and costs during the relevant testing period (in the case of a forward-looking DSCR, often relating to the succeeding twelve-month period and in relation to the LLCR, from the testing date through to final maturity of the debt).

7.42 In projecting the forward-looking DSCR and LLCR, the project company will typically use an updated banking case applying, in all cases, the then current technical and cost assumptions. In certain circumstances, the credit agreement will call for the use of the then current economic (including pricing) assumptions whilst in others, the economic (including pricing) assumptions used in the original banking case at the time of financial close will be applied.

7.43 Procedurally, the project company usually proposes the new technical assumptions, which may then be disputed by the lenders using customary contestation procedures (often referring the matter to an appropriately qualified expert).

7.44 The financial coverage ratios will be tested in a number of circumstances. These include:

(1) as a condition precedent to financial close and perhaps even to drawdowns;
(2) passing the relevant completion test;
(3) permitting shareholder distributions;
(4) incurring additional debt; and
(5) as a default trigger.

7.45 The tables below set out examples of how different ratios could be used in different circumstances and the relationship with the assumptions used in the base case Financial Model.

Table 7.1

(a) Backward-looking DSCR

Purpose	Ratio level
Distributions to shareholders	1.[•]:1 (12 months prior to the testing date).

(b) Forward-looking DSCR

Purpose	Nature of assumptions	Ratio level
Distributions to shareholders	Updated.	1.[•]:1 (12 months following the testing date).

Purpose	Nature of assumptions	Ratio level
Incurrence of replacement debt	Original (but amended to take into account the proposed replacement debt).	Is at least equal to the forward-looking DSCR for each testing date through to final maturity in the banking case delivered at financial close.
Conditions precedent (if applicable)	Original.	For each testing date through to final maturity of not less than a specified minimum.
Completion (testing)	Original (but amended to take into account the actual technical parameters demonstrated during the completion test, if less than the minimum requirements assumed at financial close).	Is at least equal to the forward-looking DSCR for each testing date through to final maturity in the banking case delivered at financial close.

(c) **LLCR**

Purpose	Nature of assumptions	Ratio level
Incurrence of replacement debt	Original (but amended to take into account the proposed replacement debt).	Is at least equal to the LLCR in the banking case delivered at financial close.
Conditions precedent (if applicable)	Original.	For the period from the testing date through to final maturity of not less than a specified minimum.
Completion (testing)	Original (but amended to take into account the actual technical parameters demonstrated during the completion test, if less than the minimum requirements assumed at financial close).	Is at least equal to the LLCR in the banking case delivered at financial close.

7.46 It is important that the ratios used in the credit agreement accurately reflect the ratios set out in the official version of the financial model and are reviewed, as appropriate, by the documentation bank or technical adviser. The definitions should follow the appropriate accounting convention used by the borrower, and if necessary, with changes being made to the IFRS-based[15] definitions used in, for example, the LMA standard form financial covenant definitions.

[15] IFRS are the international accounting standards within the meaning of IAS Regulation 1606/2002 to the extent applicable to the relevant financial statements.

Events of default

7.47 Only a credit agreement in which the debt is repayable on demand of the lender is complete without events of default. If they were absent from loan agreements, lenders would have to look to general contract law for remedies, which is not ideal. On the other hand, the inclusion in the credit agreement of events of default gives lenders the ability to bring the lending relationship to a premature end, should a change in circumstances make this appropriate, with clear pre-agreed remedies, without the need to head for the law courts. Their occurrence will also normally automatically suspend the ability of the borrower to request further advances under the credit agreement whilst simultaneously preventing distributions to the sponsors or, where they exist, more junior creditors. Lenders will also usually become entitled to receive enhanced information and site visit access rights. The lenders will also customarily acquire a freer hand to transfer their loan holdings to third parties without reference to the borrower, an action that could bring more aggressive or non-relationship lenders into the project. But the biggest threat posed to the borrower by the event of default is the ability that lenders then acquire to accelerate outstanding loans; acceleration will typically cross-default all of the borrower's debt and almost certainly lead to insolvency. It is therefore an option that lenders would exercise only if no further assistance can be found in working out of the distressed scenario.

7.48 The events of default in a project financing will mirror those in other financings, including in respect of:

(1) the failure to repay principal or to pay interest and fees when due;
(2) breach of financial covenants;
(3) breach of general undertakings;
(4) misrepresentations by the project company and other obligors;
(5) impairment of the transaction security; and
(6) the insolvency or bankruptcy of the borrower.

7.49 The credit agreement will also contain events of default that address any material adverse effect on the project by reason of:

(1) misrepresentations and breaches of covenants by counterparty to a material project contract;
(2) material adverse changes in law or governmental authorizations;
(3) the bankruptcy or insolvency of counterparties to the project contracts;
(4) loss of regulatory licenses, permits, or exemptions;
(5) failure by the shareholders to fund any equity support arrangements or to comply with share retention covenants;
(6) expropriation by governmental authorities; and
(7) failure to complete the project or commence operations by a date certain.

Clearly, the most controversial of these relate to defaults triggered by the conduct of persons or conditions beyond a borrower's control. The reader is referred to

Appendix 1 for a checklist of events of default which are typically included in a project financing credit agreement.

Remedies

7.50 Following an event of default, the credit documentation generally sets out the remedies afforded to a lender, including the right to:

(1) cancel the commitment to advance funds;
(2) declare the loans to be due on demand or to accelerate the maturity of the loans; and
(3) exercise the rights of a secured creditor under the security agreements.

Additional remedies may allow the lenders to assume the construction and operation of the project or to cure defaults by the project company under any of the project contracts. It is advisable, however, for the lenders to consult with counsel to ensure that these remedies do not result in liability to third parties. For example, liablility may attach to lenders and other persons exercising control over a thinly capitalized project company.

7.51 To exercise the remedies, the credit agreement will usually require the lenders' agent to deliver a notice to that effect, sometimes only while the relevant event of default is continuing, i.e. has not been cured or waived. It is important that any such notice is given in accordance with the terms of the contract.[16] Occasionally, the borrower will successfully negotiate the inclusion of a procedure to be followed in the giving of such notice, such as a notice period; in that event, that procedure must be observed, particularly where it is capable of being construed as a condition precedent to taking enforcement action. The agent will usually, even where it is given the power to accelerate, request to be authorized to deliver the notice of acceleration by a majority of the lenders.

Accounts Agreements

7.52 Since a true project financing is non-recourse to the sponsor's balance sheet, with cashflows from the project's assets and operations being the only source of debt service and repayment, the project accounts and the cashflow will be jealously guarded by the creditors via elaborate, and occasionally onerous, restrictions regulating the flow of cash and its allocation. The lenders will insist on having access to virtually all available cashflow in the forward years of the project and will use the

[16] *Re Berker Sportcraft Ltd's Agreements, Hartnell v Berker Sportcraft Ltd* (1947) 177 LT 420.

loan financing documents to impose covenants on the use to which the project's revenues must be applied.

7.53 The creditors will exert control through a 'waterfall' of accounts, so called because funds initially go into the receipt or revenue account at the top and then cascade through the operating account, the debt service account (for the payment of current principal and interest) and various reserve accounts (generally including a debt service reserve account (DSRA), into which a reserve for future debt service payments, often calculated on the basis of six months' debt service, will be set aside). The cascade defines the priority of uses for the project's cashflow, which will take on significance when actual revenue falls below operating cost requirements. At the bottom of the waterfall is an account from which dividend distributions will be permitted to be paid to the shareholders of the project company.

7.54 The project company is typically permitted to withdraw funds from the operating account solely to cover approved operating expenses, from the reserve accounts to fund specified costs, and from the project company's distributions account to fund distributions to its shareholders, so long as the conditions for withdrawal set out in the credit agreement have been satisfied. The lenders will generally have security over the accounts and the balances contained within them, and they will often seek the right to assert broader control over the use of the funds held in the accounts upon the occurrence of a default or other adverse conditions.

7.55 The waterfall and other accounts operating mechanics, as well as provisions governing the relationship between the account bank, the other finance parties, and the project company, will be detailed in the common terms agreement or in a standalone accounts agreement. The latter is likely to be more appropriate where the account bank is not also lending to the project and prefers not to be party to the common terms agreement or where a different governing law applies to the accounts, particularly in relation to the onshore accounts. The accounts agreement will also be useful in disapplying certain rights that the account bank enjoys, either under the normal banker-customer relationship, or pursuant to its normal bank mandates. Lord Cottenham LC's statement in *Foley v Hill* describing the features of the banker/customer relationship makes plain why express account provisions are needed to counteract the effects of the normal banker-customer relationship:

> Money, when paid into a bank, ceases altogether to be the money of the principal . . . it is then the money of the banker . . . ; he is known to deal with it as his own; he makes what profit on it he can, which profit he retains to himself, paying back only the principal, according to the custom of bankers in some places, or the principal and a small rate of interest, according to the custom of bankers in other places. The money placed in the custody of a banker is, to all intents and purposes, the money of the banker, to do with it as he pleases; he is guilty of no breach of trust in employing it; he is not answerable to the principal if he puts it i/nto jeopardy, if he engages in a hazardous speculation; he is not bound to keep it or deal with it as the property of his principal, but he is of course answerable for the amount because he

> has contracted, having received that money, to repay the principal, when demanded, a sum equivalent to that paid into his hands. That has been the subject of discussion in various cases, and that has been established to be the relative situation of banker and customer.[17]

7.56 In a financing involving international lenders and in cases where there are concerns about political risk in the host country or the enforceability of local security, the project accounts will, subject to applicable local regulatory requirements, typically be maintained in one of the principal financial centres, usually London or New York. Debt and equity proceeds as well as project revenues will be paid into and maintained in the offshore accounts, with transfers made periodically (usually monthly) to a local account in an amount sufficient to meet budgeted expenditure until the next scheduled transfer.

7.57 The key provisions in the accounts agreement will address the following:

(1) *Acknowledgment of security*: The accounts agreement will generally be used as the means by which the project company gives notice of the security created over the project accounts (and any monies paid into such accounts from time to time). The account bank will also usually be required to undertake not to claim or exercise any rights of set-off, combination or consolidation of accounts, or any other rights over the project accounts or investments purchased out of account balances. Without this clause, the account bank could, under the normal banker-customer relationship, appropriate the money in the accounts against liabilities owed to it by the project company, ahead of the lenders.
(2) *No other accounts*: The project company is usually prevented from establishing any other accounts beyond those prescribed in the accounts agreement without the prior written consent of the lenders. Such consent would typically only be given if the additional accounts are regulated by the accounts agreement (usually achieved by being opened with the account bank or accession by the new account bank) and are charged to the same extent as the existing project accounts for the benefit of the secured parties.
(3) *Instructing party*: The borrower will usually retain full access to the project accounts prior to the occurrence of an event of default and the account bank will usually be entitled, without further verification, to allow the project company to operate the project accounts in accordance with the provisions of the accounts agreement until such time as it is notified by the finance parties that an account blocking event has occurred or that the finance parties have voted to enforce their security over the accounts. Upon the lenders taking enforcement action, the account bank will be obliged to honour only the instructions given by the finance parties. Access is sometimes restricted progressively, initially through a 'lock-up' that prevents distributions being made to the

[17] *Foley v Hill* (1848) 2 HL Cas 28 at 36, 37, [1843–60] All ER Rep 16 at 19.

sponsors if a potential event of default occurs. When the potential event of default matures into a full event of default, the borrower's powers to operate the accounts are often further curtailed, ranging from preventing it from being able to operate certain accounts, to altogether losing the ability to manage the accounts.

(4) *Waterfalls*: The principal demarcation as to the application of account balances (and therefore the applicable 'waterfall' structure) will be informed by whether the use occurs during the construction phase or operations phase; and/or before or during the occurrence of a default. Each such phase will normally have a specific priority waterfall that can be summarized as follows:

(a) *During the construction phase*: Subject to local regulatory requirements, the debt and equity proceeds will be deposited into a single account, usually, out of which funds will be drawn periodically to pay project costs as they fall due. During this phase, the payment cascade will be quite limited. Project costs will be given priority. Separate accounts will be maintained for contingency based receipts such as insurance recoveries. An issue that sometimes engenders discussion is the application of revenues generated during the start-up phase of the project where project completion has not occurred, but the project has in fact become revenue generating. Where the amounts generated are significant, the lenders usually insist on exercising some control over such proceeds, either by requiring that they be applied towards prepaying the senior debt or funding senior debt service reserves. Commonly, the answer lies in the lenders sharing the pre-completion revenues with the shareholders. At the end of the construction phase, the balance on the account will be transferred into a revenues account, into which the project's revenues will also be paid.

(b) *During the operations phase*: After project completion, the typical waterfall will allow operating costs to be paid out first ahead of senior debt service in order to maintain the ability of the project to generate cashflows while permitting distributions to be made to the project owners if all other cash requirements are addressed. A simplified cash waterfall during the period from project completion might be structured to include the following priorities:

(i) *firstly*, to pay operating costs and taxes;
(ii) *secondly*, to pay the lenders' agents' fees, costs and expenses;
(iii) *thirdly*, to pay debt service due on the next repayment date;
(iv) *fourthly*, to pay mandatory prepayments, if any;
(v) *fifthly*, to fund the DSRA up to the required balance;
(vi) *sixthly*, to fund other reserve accounts up to the prescribed balances;
(vii) *seventhly*, to pay voluntary prepayments, if any; and
(viii) *finally*, if the distribution conditions are met, to make distributions to the equity parties.

   (c) *During an event of default*: The project company will customarily be prevented from making payments to the equity parties where on event of default is continuing. The rest of the waterfall will usually remain intact, until such time as the lenders choose to take enforcement action.

(5) *Distribution and dividend restrictions*: The accounts provisions usually restrict the project company's ability to make dividend payments or distributions of any kind unless the prescribed preconditions have been satisfied, which include, for example, requirements that:

   (a) the sponsors have made their equity contribution in full;
   (b) there are no outstanding defaults;
   (c) the specified financial cover ratios continue to be met; and
   (d) all reserve accounts (for example, maintenance and debt service reserve accounts) are fully funded.

(6) *Cash traps*: Project finance credit agreements sometimes also require the project company to use excess cashflow to make mandatory prepayments of loans or to fund special reserves if circumstances occur that increase the project's risk profile from the lenders' perspective. For example, projects that are exposed to market risk for fuel or output may require reserves to be established if market conditions indicate that fuel costs may be rising above, or that output prices may be falling below, projections or assumptions made in the financial model. The lenders may also require cashflow capture if, for example:

   (a) the project fails to obtain an important contract or a governmental permit by a given date;
   (b) operating costs exceed budgeted amounts; or
   (c) in the case of oil and gas or mining projects, the project depletes its fuel or mineral reserves at a faster rate than projected in the financial model.

   By capturing cashflow, the lenders reduce their immediate exposure and improve the economics of the project.

(7) *Acceptable credit support*: It is common for the project company (or the sponsors) to be permitted to substitute the cash balances in certain reserve accounts (including the DSRA and any maintenance reserve accounts) with acceptable credit support, usually taking the form of a letter of credit or guarantee issued by an acceptable entity with a suitable credit rating. Lenders tend to require that the issuer or provider of any acceptable credit support may not have recourse to the project company or its assets and is fully subordinated to the senior creditors. Sponsors with credit ratings which are acceptable to the lenders may be able to put in place a corporate guarantee instead of a letter of credit. Where the sponsors are acting through a joint venture and one or more is not able to fund its proportional share of acceptable credit support at the same time as the other sponsors are providing acceptable credit support, they may insist on transferring their proportional share to a separate account in the name of the

non-funding sponsor so that they can have the benefit of any interest accruing on such accounts. Lenders usually accept this provided that the separate account is secured to them and the relevant sponsor is entitled only to receive interest (on a post-tax basis) accruing on amounts standing to the credit of the account.

(8) *Access to books and records and confidentiality*: To enable the finance parties to police the accounts, the project company will authorise the account bank to give access to the books and records held by it on the accounts to the finance parties and authorise the account bank to waive any general duty of confidentiality that it may owe to the project company.

Shareholder Senior Facilities

7.58 Occasionally, a sponsor or its affiliates may provide debt to the project company to fill funding gaps arising from a shortfall in the amounts raised from the other senior lenders. Strong sponsors, particularly in the oil and gas sector have been successful in procuring that that debt ranks *pari passu* with the other senior debt, subject to the commercial terms of each tranche of the shareholder senior facilities being no more favourable than the corresponding tranche being bridged on the basis of the base case financing plan. For instance, if the shareholder senior loan is bridging a commercial bank tranche, it would be expected to bear the same (or a lower) margin. Similarly, the tenor of each affiliated senior debt tranche would be equal to (or greater than) the tenor of the corresponding tranche being bridged as reflected in the base case financing plan.

Mezzanine Facility Agreements

Introduction

7.59 The reader will have been introduced to mezzanine debt in Chapter 3.[18] While mezzanine structures can often plug gaps in a financing plan and have been seen in the straitened times that have affected the market since the credit crunch, mezzanine finance is rarely encountered in project financings and is more readily associated with the leveraged buy-out market. However, mezzanine debt structures in project financings do exist, as seen in the Worsley multi-fuel cogen project in Western Australia which featured mezzanine debt in the form of preferred return instruments. Mezzanine facilities have also been incorporated in a number of renewable energy project financings and infrastructure projects.

[18] See para. 3.20 et seq.

7.60 Mezzanine debt is a type of subordinated debt that ranks below senior debt and above equity, or in more complex financings, above junior debt. Mezzanine debt will sometimes allow the mezzanine lenders to convert all or part of their debt into equity where the project is unable to service the debt on time but remains fundamentally sound on a longer-term outlook. Specialist lenders will typically provide mezzanine funding that more traditional lenders are not able or willing to underwrite, either because the specialists lenders see opportunities in the enhanced margin or convertible aspects that enable them to share in the equity upside or because they have a strategic policy reason for taking on the enhanced risk. A number of ECAs and DFIs have chosen to participate in both senior and mezzanine or other subordinated debt tranches, particularly in the mining sector in the recent past, thus spreading pricing and risk across facilities. Sponsors and owners might also view mezzanine debt as a means of optimizing their financing plan, and rather than seeing the increased risk as a threat, they will focus on the debt characteristics of mezzanine finance that present important advantages over equity, such as tax deductibility, lower funding costs, and higher returns on investment. Traditional mezzanine lenders have largely avoided exposure in emerging markets because of concerns surrounding legal codes and greater operating risks. Mezzanine finance as a product is therefore more prevalent in jurisdictions with stable and predictable legal frameworks, particularly those recognizing debt subordination and having less interventionist insolvency regimes.

7.61 Mezzanine debt may also involve extending credit to the sponsors, with the mezzanine lenders taking a charge over the sponsors' equity interests. The need to take such security could therefore lead to a multi-tiered shareholding structure to enable the mezzanine lenders to have exclusive share security at the level that is above the senior lenders. This would enable the mezzanine lenders to take over the equity interests without interfering with the underlying project financing or having to find cash to buy out the senior lenders. Alternatively, the mezzanine debt could be advanced at the project company level, with the mezzanine lenders agreeing to rank behind the senior lenders in the project's cash waterfalls, but ahead of the more deeply subordinated creditors and the equity.

7.62 This form of financing may include subordinated/junior debt, preference shares, and convertible notes. A mezzanine facility will reflect the fact that the mezzanine lenders are being compensated for accepting an enhanced level of risk relative to the senior creditors. Thus, the mezzanine facility agreement will generally reflect lower financial cover ratios and a higher interest rate to compensate the mezzanine lender for its subordination to the senior debt.

Key features of mezzanine facility agreements

7.63 *The return*: Mezzanine financings encapsulate a variety of structures which are shaped by the financing objectives of the parties. However, it is possible to identify

characteristics that will at least be given some consideration by the parties in developing a mezzanine facility agreement. Mezzanine lenders look for a certain rate of return which will reflect the longer maturity profile that defines mezzanine debt and which usually results in its full retirement after the senior debt has been paid in full. This means that these aspects of mezzanine debt will not be suited to the lenders whose internal requirements do not permit this level of deferral:

(1) *PIK interest*: In addition to the traditional cash interest, mezzanine finance will typically feature a 'payment in kind' interest element that allows accrued interest to be capitalized rather than being paid in cash.
(2) *Equity interest*: Mezzanine capital will often include an equity stake in the form of attached warrants or a conversion feature.

7.64 *The borrower*: Mezzanine financings can be made at either the project company level or at a holding company level above the project company, depending on the type of subordination required by the senior creditors and other interested constituents.

7.65 *Passive rights*: The rights of the mezzanine lenders in the project finance/PFI/PPP market are narrower than those they are accustomed to enjoying in, for instance, the leveraged buy-out debt market, where they typically are actively involved in decision-making and taking enforcement action, subject only to temporary standstill periods. In a number of project financings and PFI/PPP transactions, the senior lenders have required a 'silent' mezzanine tranche, i.e. the ability of the mezzanine lenders to take or initiate enforcement action will be heavily curtailed, while being permitted intercreditor rights with respect to a very limited universe of matters, usually those that would directly affect their debt. In effect, the senior lenders have regarded and treated the mezzanine tranche as another slice of the equity. However, this is usually accepted by mezzanine lenders in relation to project financings, not least because they may also hold senior debt and will choose to exercise their influence at that level. In rated transactions, the major credit rating agencies generally express concern about the ability of mezzanine lenders to interfere with the senior lenders' debt and security package. To address their concerns, creative structures have been developed to subordinate the mezzanine debt structurally by interposing a mezzanine borrower holding company at a level above the borrower of the senior debt with the mezzanine lenders being given exclusive security over a limited range of assets, such as accounts at the holding company level and share security over the mezzanine borrower holding company. The senior lenders will then be less concerned with the mezzanine lenders having rights to make decisions or take enforcement action at that structurally subordinated level, since their actions would be less likely to interfere with the senior debt. There are a number of reasons why the senior lenders in the project finance/PFI/PPP market take a more aggressive stance against the more junior or mezzanine tranches in the finance structure. These range from the relatively lengthy tenors of the senior debt, to the

fact that mezzanine lenders are seen as potentially short-termist, a view that some consider to be unjustified.

7.66 *Cashflow waterfall priority*: Mezzanine debt service customarily ranks below senior debt service and the funding of the senior debt service reserve account, but above more junior, subordinated debt. It will also be subject to a lock-up test akin to that applicable to the payment of dividends. In a contractually subordinated structure, negotiations on the waterfall priority tend to focus on whether other reserve accounts, such as maintenance and capital expenditure reserve accounts, should rank ahead of mezzanine debt service. Parties also strongly debate the levels of the lock-up tests, with the senior lenders looking to set them at the same level as those that apply to the equity participants.

7.67 *Exclusive security*: Where the mezzanine lenders are given exclusive security, they will take a first ranking security interest over the:

(1) mezzanine debt service reserve account;
(2) mezzanine lock-up account; and
(3) (if the mezzanine lenders are lending to a holding company above the project company) shares of that holding company.

In respect of common security (if any), they will either hold second ranking security (behind senior lenders) over the assets of the borrower, or share first ranking security with the senior lenders, but with an entitlement to recoveries only to the extent that the senior lenders are paid in full. Shares in the project company may form part of the common security.

Selected mezzanine facility agreement issues

7.68 The mezzanine facility agreement will usually be drafted only after the senior facility agreement has been advanced to a reasonable degree. This is because the two agreements will be substantially similar, with only a few sections being altered to give the mezzanine facility agreement its distinguishing features. The following are some of the sections that will customarily be adjusted:

(1) *The purpose clause*: This will allow the mezzanine debt proceeds to be applied towards the payment of mezzanine fees and debt service.
(2) *Drawdown provisions*: The agreement will clarify whether the mezzanine lenders can influence the determination as to the satisfaction of conditions precedent, particularly in relation to those disbursements that occur after financial close, and whether proceeds are paid into a dedicated proceeds account (over which the mezzanine lenders may have exclusive security) or whether the debt proceeds are intermingled with the senior debt proceeds, and therefore come within the common security package. Where the commercial understanding is to regard the mezzanine debt as equity, the senior lenders may insist on the mezzanine debt being available to be drawn to repay accelerated senior debt.

(3) *Repayment clause.* The key debate here will be seen in determining the circumstances in which the senior lenders will be entitled to prevent the project cashflow reaching the mezzanine lenders through the lock-up tests in the senior facility agreement (or any common terms agreement). The mezzanine facility agreement will similarly set out lock-up tests that restrict payments to more junior debt and the equity.
(4) *Yield protection*. Mezzanine lenders may require prepayment fees to compensate them for loss of expected realizations due to an early retirement of all or part of their debt. This is by no means a feature that is unique to mezzanine debt (for example, ECA debt tranches may also provide for prepayment premia), but whether or not the mezzanine lenders are able to secure this would be determined by the relative bargaining strength of the parties.
(5) *Covenant package*: The mezzanine covenants will typically follow the senior covenant package. However, additional covenants and different ratio thresholds will be required to reflect the mezzanine debt's position behind the senior tranche. The mezzanine facility will also set out restrictions to avoid cash leakage to more junior debt or the equity in much the same way as the senior facility.
(6) *Mezzanine enforcement rights*: These will typically be set out in the intercreditor agreement and are discussed in more detail below.[19]

Subordinated and Equity Bridge Facility Agreements

7.69 A number of sponsors are increasingly using subordinated and equity bridge loans (EBLs) to make their equity contributions to the project company in order to maximize their return from the project and will often champion their use up to the tolerance permitted by applicable thin capitalization rules and the credit requirements of the senior lenders. EBLs are traditionally short-term loans with a tenor of up to three years[20] and a bullet repayment profile. The use of EBLs to maximize equity returns has become prevalent in the water and power sectors (particularly with respect to projects benefiting from creditworthy long-term off-take contracts). EBLs may be priced to encourage a refinancing ahead of schedule through devices such as upward margin ratchets. The senior creditors will usually be content to accept such devices but will seek to ensure that:

(1) at least a portion of total project costs (usually 10 per cent) is funded by share capital;
(2) the shareholder subordinated debt to equity ratio is capped, primarily to address thin capitalization requirements and to preserve the efficacy of subordination provisions in an insolvency;

[19] See para. 7.116 below.
[20] Although prior to the credit crunch, longer tenors stretching beyond project completion were seen in the project finance market.

(3) the EBLs are replaced with share capital on a date certain as an undertaking by the sponsors; and
(4) the EBLs are fully first drawn prior to the first drawdown of the senior debt tranches.

7.70 *Credit risk*: Except where all of the equity is contributed up-front, the sponsors' credit-worthiness will have to be satisfactory to the lenders; alternatively the sponsor will be required to provide acceptable credit support, usually in the form of letters of credit, from an acceptable rated provider, including where the sponsor's rating deteriorates below an acceptable threshold. In this instance, the parties will need to assess the margin payable on the equity bridge loan against the cost to the sponsor of paying the fees to the provider of the acceptable letter of credit. Occasionally, the senior lenders will accept a corporate guarantee from a sponsor with a particularly strong credit rating. From time to time, sponsors will also seek to provide credit support only where their own credit rating falls below a prescribed level. This is normally only applicable in the case of the very strongest credits. Once the EBL lenders are comfortable with the credit of, or credit support provided by, the sponsors, the issue of whether an equity bridge is funded prior to the senior debt or whether equity will be 'back-ended' is largely a mechanical one.

7.71 *Subordination*: Lenders providing an equity bridge loan will usually do so without taking any security over the project's assets and with no recourse to the project company. EBL lenders will either accede to the intercreditor agreement or enter into a separate subordination deed to confirm the junior, non-recourse nature of their debt but they will not usually take part in any voting, nor will they receive the proceeds of any enforcement action.

7.72 *Drawdowns*: It is likely that equity bridge loans will be drawn before the senior facilities because they usually have lower margins (thereby maximizing the equity returns). However, for example, where even lower funding costs are available from other sources (for example, 'soft loans'), it may be possible to substitute the usual requirement that the EBLs be fully drawn prior to the drawdown of the senior debt tranches, with an undertaking to make the EBLs available pro rata with the senior debt, with the result that at any given time (and absent the occurrence of any particular events that entitle the senior lenders to require the sponsors to fund their equity contributions in full) the funded exposure of both sponsors and lenders as a proportion of their respective commitments is the same. Indeed, with the increased use of equity bridge loans in project financings, particularly within the water and power sector, it is often now the case that the sponsors do not actually fund their equity contributions to a project until project completion or later (although of course the fact that they have guaranteed the equity bridge loan means that their credit exposure to the project is essentially no different to that which it would have been had they made their equity contributions to the project company in the usual way).

7.73 *EBL debt service*: EBL debt repayment obligations are usually non-recourse to the project company; thus, neither the proceeds of senior debt nor the project company's cashflows may be applied to retire the principal of the EBL. However, current interest payments on the EBLs are usually payable out of the project cash waterfall up to a capped amount, unless a default of some sort occurs; the sponsor credit support provider will guarantee the obligations of the project company to pay such financing costs on a non-recourse basis, with the result that if the project company fails to pay the financing costs or another event of default relating to that sponsor arises under the EBL, the EBL lenders will be entitled to accelerate the EBL facilities (and in turn to take steps to exercise their rights against the sponsor credit support provider), but would not otherwise be able to take any action against the project company, including in its insolvency.

7.74 *Cross-default to senior loan*: It is generally the case that a breach under the EBL will not trigger a default under the senior credit agreement. Senior lenders generally take the view that:

(1) during the construction period, once the EBL loan has been injected into the project and suitably subordinated, it is of little moment that the EBL loan is in default; and
(2) following project completion, any failure to pay interest on (or, indeed, principal of) the EBL is simply akin to a shortfall in dividends.

Clearly, if the EBL is to be funded pro rata to the senior debt, such that an EBL default will trigger a drawstop under that facility, the senior lenders will have a greater concern with the existence of the default, particularly as the drawstop will likely result in a shortfall of funds needed to meet total project costs. A common solution in that case is for the senior loans to default, and therefore cease to be available to be drawn.

7.75 *EBL lender protections*: To protect their position, the EBL lenders will:

(1) require a hedging programme in respect of any interest rate or currency risk;
(2) in recognition that it represents their sole recourse for the recovery of the principal amounts advanced to the project company, ensure that their ability to call on the credit support is unfettered by any other party (including the senior lenders);
(3) require that any payments due to the EBL lenders from a credit support provider are made directly to the EBL lenders;
(4) agree to a cap on the level of the sponsor credit support. However, the EBL lenders in these circumstances are likely to wish to ensure that the cap:
    (a) has a significant LIBOR-based buffer to take into account both interest over an agreed period beyond the repayment date of the EBLs and any enforcement costs; and

(b) does not extend to hedging (i.e. if the EBL hedge providers are to benefit from a guarantee, it should be a separate guarantee designed exclusively to cover hedging liabilities).

7.76 *Documentation*: The inclusion of an EBL in a financing plan usually necessitates a separate loan agreement between the project company, the relevant sponsors and the EBL lenders. Due to the intercreditor issues which may arise, separate counsel may also be required to advise the EBL lenders.

ECA Covered Facilities

7.77 As discussed in Chapter 8, many ECAs will, in their official export credit support role, act under the aegis of the OECD Arrangement on Officially Supported Export Credits.[21] ECA support may be provided by way of export credit guarantees or insurance or through direct credit/financing and refinancing or interest rate support. Thus, in a project financing, ECAs may provide insurance cover to exporters or lenders or guarantee payments to the lenders that are making advances to an overseas borrower. Such insurance cover or guarantees may be comprehensive (i.e. provide commercial and political cover) or provide only political risk cover.

Documentation

7.78 There is no standard form of documentation across the ECA universe and each entity will have its own preferred forms. However, in international syndicated transactions, an LMA-based form is often used as a starting point for the documentation.

7.79 The OECD Arrangement[22] allows ECAs to provide flexible loan repayment terms to match a project's revenue stream and transactions can be structured with sculpted repayment profiles and flexible grace periods within the rules and subject to market practice in the relevant industry sector. This is particularly beneficial to projects in, for example, the petroleum refining and telecommunication sectors which see seasonal volatility in their cashflows and for whom temporary deferral of principal repayments is critical to avoid breaching their financial covenants (even where the overall project economics remain robust).

Eligibility criteria

7.80 A number of ECAs have gradually relaxed their eligibility rules as they seek to become more competitive in the market place.[23] Most ECAs are enjoined only to

[21] See para. 8.20 et seq.
[22] See para. 8.20 et seq.
[23] See also para. 8.11 et seq.

support projects that have a sufficient nexus with their own countries, whether that nexus is a local off-taker, equipment supplier, or EPC contractor. The purpose clause of most facility agreements will therefore require that the proceeds from the ECA facilities are applied towards payment or reimbursement of project costs incurred in purchasing eligible goods and services under eligible construction and supply contracts. Increasingly, what constitutes a local component in a project is given a liberal interpretation in an effort to support a country's industry and exports.

Bribery and corruption—OECD Guidelines

7.81 ECAs are encouraged to combat the bribery of foreign public officials in international business transactions benefiting from official export credit support by the OECD Recommendation on Bribery and Officially Supported Export Credits, which was adopted by the OECD Council on 14 December 2006. Recommended best practice includes looking for red-flags by verifying whether the exporters and applicants are blacklisted by international financial institutions or have been indicted for bribery in the previous five years. Even where the transaction passes the ECAs' initial due diligence, the ECAs are urged to:

(1) require that exporters and applicants provide an undertaking or declaration that neither they nor anyone acting on their behalf have been engaged or will engage in bribery in the transaction; and
(2) take 'appropriate action' (such as denial of payment, indemnification or refund of sums provided) if bribery is subsequently proved.

7.82 It is therefore now standard practice for the common terms agreement or the relevant facility agreement to contain a representation to the effect that neither the project company nor its representatives have paid or sanctioned the payment of a bribe or similar payment in relation to the project (coupled with a covenant that they will not make such payment at any time in the future). A breach of this representation or covenant and the potential reputational damage that could ensue gives the ECAs the right to accelerate their debt.

Policing environmental covenants

7.83 Another feature that has become a fixture in ECA finance documentation is a package of measures designed to ensure that the ECA-supported project does not endanger local communities or the environment. This derives from the adoption in 2001 by the OECD of the Recommendation on Common Approaches on the Environment and Officially Supported Export Credits (the Common Approaches) for evaluating the environmental impact of ECA supported infrastructure projects to ensure that they meet established international standards. The Common Approaches were strengthened in December 2003 shortly after the private sector-focussed Equator Principles came into force, and again in 2007 when

they were further revised and expanded. Adherence to the Common Approaches is intended to increase transparency in official ECAs' environmental review processes to ensure consideration of the environmental effects of projects on a consistent basis.

7.84 The Common Approaches are not legally binding but are adhered to very firmly in practice and are viewed as capable of impacting the bankability of a project. They require that both new projects and projects undergoing significant change in output or function are evaluated against the environmental standards of the host country or international standards against which the project has been benchmarked, whichever are the more stringent. The relevant international standards tend to be those of the World Bank Group or of regional development banks.[24]

7.85 With regard to the most sensitive projects:

(1) the environmental standards to be applied must be reported and monitored by the OECD's Export Credit Group (the ECG)[25] and exceptional deviations from the international standards will have to be justified; and
(2) ECG members will seek to make environmental information, particularly environmental impact assessment reports, publicly available before final commitment.

7.86 Most official ECAs have established internal procedures to assess the potential beneficial and adverse environmental effects of goods and services for which support is requested and will only grant board approval for financing support after such an assessment. A number of ECAs have also borrowed a leaf from leading regional development banks and issued their own environmental guidelines, with the result that they will usually require that the loan financing documentation takes into account such procedures and guidelines.

7.87 For environmentally sensitive projects, ECAs will require the development of an environmental and social impact assessment that accords with minimum standards and will require that the assessment is publically disclosed to interested parties for a minimum period[26] or direct interested parties to a source, such as a publicly accessible website, where it can be reviewed. This disclosure requirement can have a timing implication on a proposed signing or closing and should always be taken into account in structuring the transaction schedule.

[24] These include the African Development Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development.

[25] As of the date of writing, the ECG includes the following OECD countries: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, the UK, and the US.

[26] This period ranges from thirty days to 120 days depending on the ECA involved.

7.88 Upon signing the financing documents, a number of ECAs will summarize or disclose in their entirety the material environmental requirements associated with their financial support, including a list of the environmental reports required of the borrower, on their website.

7.89 Projects are expected to be designed, constructed, and operated in a manner that will enable them to maintain compliance, on an ongoing basis, with the environmental guidelines pursuant to which the ECA evaluated the project. If a project does not meet the applicable environmental guidelines, the ECA may reject the funding proposal or provide financial support that is conditional on the implementation of measures to mitigate the project's adverse environmental effects.

7.90 ECAs will seek to police compliance with the prescribed environmental and social guidelines and ensure that the project is constructed and operated in accordance with the relevant host-country and applicable international environmental guidelines throughout the term of their support. Monitoring is usually conducted through a desk-top review of information provided by the sponsor and regular site visits paid for by the sponsor.

7.91 In finance document negotiations, ECAs usually defer discussion on environment-related covenants pending receipt and review of the environmental and social management plan (ESMP). Nevertheless, they will invariably require:

(1) quarterly and semi-annual reporting on compliance with the construction phase ESMP;
(2) semi-annual and annual reporting on compliance with the operations phase ESMP; and
(3) mechanisms with respect to the transition of the ESMP from the construction to the operations phase and public disclosure of that ESMP on the project company's website.

Other documentation issues of interest to ECAs

Stapling

7.92 In a multi-sourced financing involving ECAs and commercial lenders, it is not unusual for the ECAs effectively to club together to ensure that they have a greater influence on the structure of the transaction and that their interests are communicated effectively. Increasingly, commercial lenders find this influence helpful, as it means that commercial lenders do not have to advocate positions that the ECAs are already espousing. To maintain their influence throughout the transaction, ECAs will often require a degree of pro rata drawdown and prepayment across all ECA facilities.

7.93 In cases where an ECA is both a direct lender and a risk policy provider or where another official institution from the same country is providing cover alongside an ECA lending directly to the project company, the ECA may insist on drawdowns

being made pro rata between the direct facility and the covered facility in a prescribed ratio, subject to a carve-out for capitalization of interest and the payment of relevant premia. Where the two institutions are financing different EPC packages in the same project, they may relax these stapling requirements, but may require the borrower to endeavour to maintain the proportionate exposures of the institutions, subject to the eligibility criteria of each ECA.

7.94 The ECAs may therefore require pro rata prepayment or cancellation of commitments across, and replacement of, all ECA facilities, but permit non-pro rata prepayments, cancellation of commitments, or debt replacements across other senior facilities. Clearly, this requirement may limit the project company's flexibility in managing its financing plan, but many view this disadvantage as outweighed by the pricing and other advantages that ECAs bring to a project.

Voting

7.95 ECAs usually insist on directing the manner in which the lenders benefiting from their cover exercise their voting rights under the financing documentation. As such, the relevant ECA facility agreement will tend to provide for the relevant ECA to control the voting behaviour of the lenders covered by its guarantee or insurance. It is reasonable to give the covered lenders an independent vote once they have ceased to have the benefit of the ECA cover or where the vote is in respect of a change that would fundamentally alter the commercial structure originally agreed to by those lenders. Thus the right to control the voting is rarely absolute. It will also be limited, for instance, in respect of the waiving of initial conditions precedent and proposed variations to provisions capable of affecting the yield to those lenders, such as the margin and repayment dates. ECAs providing direct loans to a project company would obviously be granted full voting rights.

Conditions precedent

7.96 ECAs also usually require, as a condition precedent to the initial drawdown under a covered facility, evidence that the eligible contracts have been entered into. In some cases, ECAs will require that a notice to proceed has been issued under such contracts to ensure that the project company is fully committed to sourcing content from the relevant countries.

Mandatory prepayment upon termination of contracts

7.97 Some ECAs require mandatory prepayment upon termination of the relevant export contract or a pro rata prepayment in the case of a termination of one of a number of export contracts being supported by ECA loans.

Fees and premium

7.98 ECAs will usually charge a premium for their products. Where the ECA is providing a direct loan as well as insurance or guarantee coverage, it may charge two kinds

of premium: one for the direct loan and the other for the risk policy. The direct loan premium can be included in the margin, in which case the direct loan facility agreement will not have a separate provision for that premium.

Ineffectiveness of risk policy

7.99 It will usually be an event of default under an ECA covered facility agreement if the relevant risk policy becomes ineffective. If that event of default appears in the relevant ECA facility agreement, the covered lenders will usually be entitled to cancel their commitments and accelerate the indebtedness under their facility (thereby entitling, but not obliging, all other facilities to accelerate their indebtedness as well), but they would only be entitled to call for enforcement action against the common security following a full intercreditor vote across all facilities.

Subrogation rights

7.100 The financing documentation will usually contain an acknowledgement by the borrower and the other finance parties of the right of subrogation by an ECA providing a guarantee or insurance policy to the extent that that ECA has discharged a debt obligation owed by the borrower to an ECA covered lender pursuant to such guarantee or insurance policy. The documentation usually provides that the ECA will, on being subrogated, be deemed to be an ECA lender for all purposes of the finance documents to the extent of the relevant payment. The obligation of the borrower to that ECA as subrogee will constitute an unpaid senior debt obligation of the borrower (and an event of default under the finance documents will be continuing), until that obligation is fully paid. The documentation will also make clear that this right of subrogation is in addition to any right of indemnification or subrogation that may be available to the ECA risk policy provider as a matter of general law. This provision is usually uncontroversial, but the relevant ECA will wish to ensure that it is included, to counter any argument that the ECA impliedly waived its subrogation rights by accepting other indemnities (if any) from the borrower in lieu of those subrogation rights.[27]

Intercreditor Agreements

Introduction

7.101 The desirability of an intercreditor agreement begins the moment that a project's finance plan features two or more consensual creditors. This desirability quickly turns to necessity when those creditors have differing perspectives on the risk/reward equation presented by the project company's credit. Most creditors having assessed the borrower's creditworthiness and the economic viability of a project,

[27] See e.g. *Cooper v Jenkins* (1863) 32 Beav 337. For a more detailed and useful discussion on subrogation, see C. Mitchell, *The Law of Subrogation* (Oxford University Press, Oxford 2007).

will consider the bankability standard to be met only if they are able to recover the loans advanced to the project company at least *pari passu* with other creditors. However, while some creditors will be prohibited by their internal rules from participating in a project financing on other than senior terms, others will seek to realise a better return by accepting a relatively less senior ranking. For many years, a market has developed around lenders that see opportunities in being junior, albeit secured, creditors, in the hope that the correspondingly higher margin paid to them will reflect the increased risk being assumed, both in the normal course of events and upon an enforcement of security or the insolvency of the borrower.

7.102 It is in addressing the various, often conflicting, creditor interests and priorities that the importance of an intercreditor agreement lies. As its name suggests, the intercreditor agreement is a compact among creditors, the *raison d'être* of which is the orderly re-prioritization of creditors who would, without more, rank equally at law. Thus, at the core of an intercreditor agreement will be found provisions providing for the contractual subordination to the senior debt of all other debt tranches and the application of the proceeds of the enforcement of the project security so that the claims of the senior creditors are discharged ahead of the claims of the other finance parties. But the role of the modern intercreditor agreement has grown beyond this primary function to encompass many other mechanics, largely because it is one of few documents to which each present and future project finance party is or will be a party. It is now generally accepted that such provisions are binding on the parties to the intercreditor agreement, a liquidator or administrator of any party thereto, and a liquidator or administrator appointed under the Insolvency Act of any creditor of any party thereto in accordance with their terms and will not be set aside under the rule in *British Eagle v Air France*.[28]

7.103 Secured creditors are not affected by the *pari passu* principle and the assets that constitute the collateral are not part of the insolvent's estate and are therefore not available to the unsecured creditors or to the liquidator. As amongst the secured parties, the general proposition under English law is that they should be free to

[28] The decision of the House of Lords in *British Eagle v Air France* [1975] 1 WLR 758, [1975] 2 All ER 390 makes it clear that transactions may be cut down on grounds of public policy where they are intended to avoid basic insolvency principles such as mandatory set-off and *pari passu* distribution amongst unsecured creditors. However, the contractual subordination provisions in the typical intercreditor agreement would not be set aside under the rule in *British Eagle.* The judgments of Vinelott J in *Re Maxwell Communications Corporation plc (No. 2)* [1994] 1 All ER 737 and Lloyd J in *Re SSSL Realisations (2002) Ltd (formerly Save Service Stations Ltd) (in liquidation); Manning v AIG Europe (UK) Ltd; Robinson v AIG Europe (UK) Ltd* [2004] EWHC 1760 (Ch) support the proposition that, in the context of considering the validity of the contractual subordination of the claims of unsecured creditors, the courts may not strike down an agreement between a creditor and his debtor which contracts out of the requirements for *pari passu* distribution, if that contract does not seek to provide for the relevant creditor to enjoy some advantage in a bankruptcy or winding up which is denied to other unsecured creditors. See also *Re Maxwell Communications Corporation plc (No. 2)* [1994] AER 737 and *Re SSSL Realisations (2002) Ltd (formerly Save Service Stations Ltd) (in liquidation); Manning v AIG Europe (UK) Ltd; Robinson v AIG Europe (UK) Ltd* [2004] EWHC 1760 (Ch) in para. 21(e) of Sch. 3).

allocate the assets contractually as they see fit, as an incident of their proprietary rights to the security, subject only to the terms of that security.

7.104 The modern intercreditor agreement will therefore also seek to subordinate certain classes of debt, outline payment priorities both before and after a project has gone into default, oblige creditors to turn over payments received or recoveries made out of turn, regulate the ability to take, and set forth procedures governing the taking of, enforcement action against the borrower or its assets, and the voting rights of the various creditor constituencies.

Drafting and negotiation considerations

7.105 Negotiations around the intercreditor agreement do not directly concern the borrower although it will often insist on being party to the intercreditor agreement in order to prevent amendments to the agreed voting thresholds and to certain defined terms without its consent.

7.106 During the negotiation process, the most senior creditors usually generate the first draft of the intercreditor agreement, which will be reviewed and commented upon by the subordinated creditors. The intercreditor agreement is not usually finalized until the full complement of finance documents has been largely settled. Only then can the draftsman really know what to prescribe for. However, for complex financings, it is advisable, and indeed increasingly common, to agree a summary of the key intercreditor features—the intercreditor principles—as part of the term sheet negotiations to ensure that the main commercial aspects of the intercreditor relationship are negotiated (or at least noted). Failure to do so will likely result in delay or, worse, a hastily drafted intercreditor agreement that does not properly address all the material issues.

7.107 Given the inherent conflict of interest with senior creditors, subordinated lenders often retain separate counsel (or a separate legal team at the firm appointed to act as common lenders' counsel) to advise them on intercreditor matters.[29] In any event, subordinated creditors should ensure that, as much as is possible, the intercreditor agreement contains protective provisions which, in a distressed scenario, will both preserve value and allow the subordinated creditors some influence in a restructuring situation. Needless to say, the ability of the subordinated creditors to negotiate

[29] Acting for different tiers of lenders (for example, senior lenders and mezzanine lenders) entering into a financing transaction where there is already an agreed or commonly understood structure with regard to the ranking of their respective claims, the content of their respective obligations and associated commercial issues, is one of the examples, specifically cited by the Solicitors Regulation Authority, where it may be permissible for a solicitor to act despite a conflict under rule 3.02, subject to the relevant safeguards, recognising that 'this will facilitate efficient handling of the matter (taking into account amongst other things the desire to complete the transaction quickly, the availability of necessary experience/expertise and the overall costs)'. See para. 6(a)(iv) of the Guidance to rule 3 (Conflict of interest) of the Solicitors' Code of Conduct 2007 at <http://www.sra.org.uk/solicitors/code-of-conduct/rule3.page>.

a robust intercreditor arrangement will depend on their relative negotiating strength. This cannot always be assured, such as where a rating for the senior debt is being sought and prevailing market conditions present ready alternatives to a subordinated creditor seen as being overly activist. In such circumstances, the subordinated creditors will likely find themselves being deeply subordinated as a 'silent' tranche (attractive to equity but not to others), not least because credit rating agencies charged with rating senior debt paper will take into account the ability of subordinated creditors to interfere with the senior creditors' enforcement and recovery entitlements and processes.

7.108 In March 2009, the LMA launched a standard form intercreditor agreement designed for use with the LMA leveraged facility agreement, to add to its growing arsenal of negotiation starting points. The initial version was revised six months later, to address a number of concerns raised within the London mezzanine lender community, that the initial LMA form was overly favourable to senior lenders and hedging counterparties, to the detriment of more junior creditors. In any case, it is worth noting that the LMA intercreditor agreement is designed to address the issues arising in a classical European leveraged buyout structure and, while it can be adapted to the project finance market, it may be quicker and more familiar, at least in the short-term, for experienced project finance parties to base the drafting on recent market precedent.

The typical project finance creditor classes

7.109 Unlike corporate or leveraged buyout financings, project financings have traditionally featured a relatively simple intercreditor profile, in which most, if not all, the finance parties (bar those affiliated with the sponsors) are categorized as senior creditors. As more and more sponsors and lenders in varying and wide-ranging sectors have turned to project finance, the structuring has become increasingly complex and intercreditor agreements have had to adapt to this complexity. The project finance practitioner will rarely, however, see the multi-tiered structures prevalent in the acquisition finance market. A typical project finance intercreditor arrangement might involve the following classes of creditors.

(a) Senior creditors

7.110 The senior creditor category will, in project finance transactions, typically be the broadest creditor class. The senior creditors will usually, but not invariably, be third party debt providers and hedge providers, as well as the account banks and agents under the project finance documents. The concomitant definition of senior debt will not only include all moneys advanced under the original senior facility agreements and hedging liabilities, but also permitted supplemental, additional, or replacement senior debt. Occasionally, the sponsors will insist on a senior *pari passu* ranking to the extent that they (or their affiliates) are providing senior debt

(over and above their equity commitments) or where they, for example, are supplying feedstock or lifting project production on generous credit terms. In some of the largest oil and gas financings, these credit terms can be significant, perhaps even exceeding the external senior creditors' commitments. For the benefit accorded to the project company through these terms, the external lenders may agree to share their senior status with the sponsor (or its affiliate) up to a prescribed limit subject, additionally, for example, to the sponsor or its affiliate agreeing (to the extent permitted by applicable law) to waive its set-off, retention of title and enforcement rights. Also, the affiliated senior creditor will usually only have the right to vote in respect of decisions requiring unanimity or which are capable of directly and adversely affecting its rights in its capacity as a senior creditor.[30]

(b) Subordinated creditors

7.111 Ranking immediately below the senior creditors and above the equity providers[31] is the more junior class of creditor, variously called the mezzanine or junior creditor, depending more on the features of their financing than their rights under the intercreditor agreement. In the acquisition financing market, a more defined characterization exists to differentiate the mezzanine from the junior, and the mezzanine from any 'second-lien' creditors; whatever the nomenclature, these are usually finance providers that, for a higher margin, accept a lower position in the priority of payments and recoveries. In a project financing, the subordination of these creditors is only relative to the senior creditors; they will still rank ahead of the unsecured creditors and the equity providers. DFIs have been seen to take subordinated debt tranches to plug funding gaps in the finance plan of strategically important projects.[32] Sponsors or their affiliates may also invest debt on a subordinated basis, and will usually do so for at least a part of their equity commitments, subject to restrictions imposed by any relevant thin capitalization requirements. Affiliated subordinated creditors will usually not be entitled to vote on any decision under the intercreditor agreement.

[30] For example, any amendment affecting its priority status.

[31] This work does not explore structurally subordinated debt incurred by a direct or indirect holding company of the borrower of senior debt on the basis that such structures are relatively rare in project financings, and will be more likely to arise where legal doubts exist locally as to the efficacy of contractual subordination. If structural subordination is envisaged, it is important to require that the relevant holding company is the sole borrower of the subordinated debt to protect the integrity of any senior lock-up tests and cash distribution or up-streaming restrictions within the senior loan documents or the intercreditor agreement.

[32] The EIB, for example, which took a subordinated debt position in the Moma titanium mine in Mozambique. See EIB's press release at <http://www.eib.europa.eu/projects/news/eib-financed-mine-project-in-mozambique.htm>.

Selected intercreditor issues

7.112 The more complex a project's finance plan, the more complex its intercreditor agreement will be. This section discusses some of the key issues that a practitioner may encounter in drafting and negotiating a moderately complex intercreditor agreement. The issues must of necessity be viewed from all the contrasting perspectives: the senior and subordinated creditors' and the equity parties' view points are all relevant. In a transaction with a rated debt tranche, the rating agencies will also review the arrangements for the purposes of making their ratings affirmations.

7.113 Below, we discuss, among other things:

(1) the priority of payments in respect of any money recovered by the security agent or creditor other than in the normal course of events;
(2) the universe of actions that creditors can or cannot take to enforce their rights or security in a distressed scenario;
(3) the value protective measures, if any, of which the more junior creditors can avail themselves as against more senior creditors;
(4) the voting rights enjoyed by the various creditor classes, common voting structures, and the voting thresholds; and
(5) the unique intercreditor provisions affecting hedge providers and ECAs.

Intercreditor restrictions

7.114 The intercreditor agreement will generally restrict the right of any particular lender to accelerate its debt, enforce security, initiate bankruptcy or insolvency proceedings or take other independent action that may prejudice the project, without the agreement of at least a designated percentage of the senior creditors. Following an event of default, a particular lender may, at a minimum, be restrained from exercising remedies for a specified period in order to afford other more senior lenders the opportunity to cure the default or to exercise their own remedies. The agreement will also contain provisions relating to the sharing of the proceeds derived from the enforcement of security.

7.115 The rights of subordinated creditors will generally be further restricted. The subordinated creditors will usually only be entitled to receive debt service payments on a subordinated basis in accordance with the project revenue cash waterfall set out in the finance documents, with such payments in most cases being locked-up on the occurrence of an event of default. A different waterfall will often apply upon enforcement of security to allocate the distribution of the resulting enforcement proceeds.

7.116 The rights of subordinated lenders to accelerate and take other enforcement action against the borrower will usually be subject to a 'standstill period' during which the senior creditors are given free rein to decide how to proceed. The duration of the standstill period is negotiated but a pattern has emerged. Commonly seen are durations of sixty to ninety days for payment defaults, ninety to 120 days for breach of

financial covenants and 120 to 180 days for all other defaults. These standstill periods are disapplied in the case of exclusive security (if any), against which the subordinated lenders can take action at any time, since that action should have no impact on the senior creditors. As such the more junior creditors may be permitted to take enforcement action provided that no senior debt or security is thereby compromised or disturbed, and if such enforcement action results in a change of control, that such action has no material adverse effect on the project's permits or prospects.

Subordinated creditor value protections

7.117 The senior lenders will invariably restrict the subordinated creditors' ability to take any action that could interfere with the senior lenders' ability to take enforcement action. However, the subordinated creditors and equity parties will be particularly interested in influencing the ability of the senior creditors to initiate enforcement action or alter the template on the basis of which the financing was closed. The senior creditors will be receptive to such influence only if it improves prospects for new investment or assures the senior creditors of a better chance of recovery than is otherwise available through enforcing security. The subordinated creditors will also recognise that they are unlikely to make significant recoveries if they are not proactive in influencing, as far as is feasible, the course of events. Thus, taking a view on the hold-out value of a project may result in a less passive subordinated creditor class. The following provisions in an intercreditor agreement are designed to preserve value at the subordinated levels:

(1) *Restrictions on amendments to senior documents*: The senior lenders will require the subordinated lenders' consent to amend or give any waiver or consent under any senior finance document which would:

   (a) increase the senior debt at all or by more than a prescribed amount;
   (b) increase the margin and other amounts payable in respect of the senior debt at all or by more than a prescribed amount;
   (c) change the repayment profile of the senior debt; or
   (d) change the basis on which interest is calculated.

   The ability of subordinated creditors to block amendments to the senior documents will assist syndication of the more junior debt but, from an equity perspective, will undermine the flexibility to restructure the senior debt.

(2) *Option to purchase*: Subordinated creditors will often be granted an option to purchase the senior debt in full at par after a senior default.
(3) *Subordinate exclusive security*: Where subordinated creditors have exclusive security (usually where they are structurally subordinated or where they have the benefit of credit support from parties other than the project company), they would usually expect to have the ability to enforce that security at any time

without limitation. However, such enforcement action will not be permitted if it would impede any enforcement action by the senior creditors.

(4) *Narrow standstill*: Subordinated creditors will typically be subject to a 'standstill' obligation preventing them from taking enforcement action for a fixed period whilst the senior creditors consider their options. Subordinated creditors will focus on keeping the standstill period as short as possible and may seek exemptions from it if the senior creditors commence enforcement action against the project company (in which event the subordinated creditors will be permitted to take equivalent enforcement action). Subordinated creditors may also have the right to match terms proposed by a buyer in the context of a proposed enforcement by the senior lenders. The exercise by the subordinated lenders of such matching rights is effectively a step-in right on identical terms to those of that offer.

Voting rights and structures

7.118 Often the most complexity in a project finance intercreditor agreement is found within the voting framework. It is advisable to adopt a formulaic structure based on the type of decision required to be made and the voting threshold needed to pass the relevant decision. There are a number of voting structures which creditors may adopt. To determine the appropriate voting arrangement for a particular project, one needs to assess the size of each debt tranche as this obviously has a direct effect on the proportionate voting strength of each lender group. Other considerations which need to be taken into account include whether there are differences in the maturity of the various tranches of debt, whether the financing incorporates debt with both fixed and floating interest rates, and involves risk policy providers who are likely to seek to control the votes of the lenders benefiting from their risk cover. For a number of lenders, the key consideration will be to maintain the 'day one' balance of power for as long as possible, particularly where institutions with different commercial or policy drivers are involved. In certain financings, it may be appropriate for there to be 'block voting', whereby a majority vote within a particular lender group is deemed to be a unanimous vote of that particular group when the votes of all the relevant facilities are aggregated (usually by the intercreditor agent).

7.119 Variations to loan financing documentation, waivers, and consents or determinations must usually be agreed to by a prescribed majority of the creditor group. However, matters of a purely administrative or routine nature are often delegated to a facility or intercreditor agent without the need for referring such matters to a vote by the lenders. Whether or not these agents feel able to exercise these discretions is another matter altogether and many will be reluctant to do so in the absence of a satisfactory indemnity from the lenders.

7.120 Certain decisions will, however, be seen as affecting the basis on which credit approval for a particular project was originally obtained or as having the potential

fundamentally to alter the economics of the project. In such cases, there will be a requirement for the approval of each creditor class. Such decisions customarily include:

(1) confirming satisfaction of, or waiving, initial conditions precedent to funding by the lenders;
(2) variations to the cash waterfall;
(3) changes to applicable interest rates or principal amounts owed to the lenders;
(4) the release of security;
(5) changes to the priority ranking of debt tranches;
(6) amendments to voting thresholds and related definitions;
(7) material changes to the intercreditor provisions; and
(8) extensions to the availability period of the facilities or increases in a creditor's commitment.

7.121 There is no standard approach to setting voting thresholds required to pass a particular creditor decision. A number of transactions adopt three thresholds: simple majority, super-majority, and unanimous consent. The simple majority is usually either over 50 per cent or 66.67 per cent, whilst super-majority thresholds range from 66.67 per cent to 85 per cent. Occasionally, a fourth level may be interposed between the simple majority and super-majority thresholds. The key drivers for determining the thresholds will be precedent transactions in the relevant sector and the identity and character of the creditor group. Clearly, setting a threshold too high for a routine matter that then ends in impasse, to the detriment of the project, is in no one's interest. Equally, setting the bar too low will be unattractive as it could alter the commercial parameters on which the lenders' original credit approvals were based without due scrutiny. If unanimity is required, waivers may prove impossible or expose a borrower and the other lenders to the risk of being taken hostage (in commercial terms) by an intransigent or rogue creditor. If a simple majority is adopted, individual lenders may be concerned that their views will be rendered to be of no consequence.

7.122 Figure 7.1 below sets out an example of a four-tier threshold decision matrix and identifies the type of decisions within each category.

7.123 *Calculation of voting entitlements*: Voting rights are usually determined by the exposure that a particular creditor has to the project, the so called 'skin in the game' test. This will usually be predicated on the amount of money each creditor stands to lose and which is readily identifiable. Thus, most financings will use the yard stick of the principal amount of loans outstanding owed to each lender plus, before the debt is fully drawn (i.e. during the availability period), each lender's undrawn commitment. However, if enforcement action is to be taken during the availability period, the undrawn commitments will be ignored in recognition of the fact that such commitments will not give rise to further losses. In any post-enforcement situation,

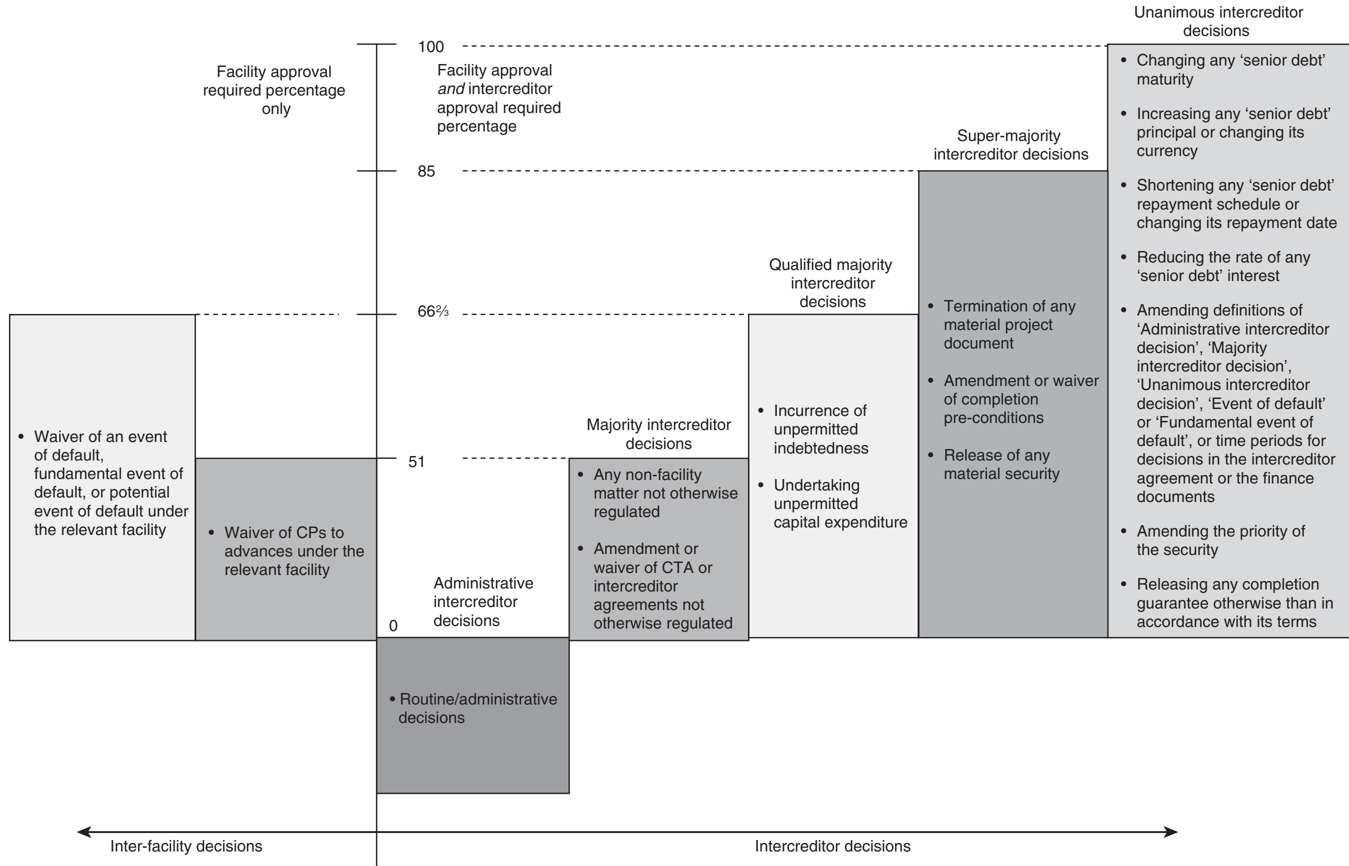

Figure 7.1 An example of intercreditor decision thresholds