Enforcement of the mortgage

12.48 The registration of the mortgage in France is only valid for a limited time (up to thirty-five years as from the registration date, subject to renewal), which time limit must be specified in the notarized deed as well as in the registration application.

12.49 One of the requirements of a mortgage is that it has the 'virtue' of constituting *per se* an enforcement instrument ('*titre exécutoire*') which means that the mortgagee holding the instrument does not need to obtain from the court a recognition of legal title before implementing the enforcement of such mortgage. In other words, enforcement is not subject to litigation in respect of the secured claim. It is similar to a final judgment. Enforcement begins by a seizure procedure. However, before any seizure, the mortgagee must serve on the mortgagor a '*commandement*' (formal demand) to pay. This formal demand will have the effect of attaching the real property as well as all rents generated by it as from the day of the publication of the formal demand at the land registry. Filing of a '*cahier des charges*' (terms and conditions of foreclosure) is also required. Finally, an auction is carried out.

Costs of the mortgage

12.50 The mortgage is regarded as being an expensive security to record as taxes and fees to be paid in connection with this security are generally calculated on the basis of the amount secured by the mortgage. For example, the amount of taxes and fees to be paid in respect of French mortgages are approximately equal to 1.1 per cent of the amount of the secured loan. Depending on the amount of the financing and the value of the property, the amount of the taxes may be significant and should be taken into account in the financial model.

Purchase money security interest (lender's lien)

12.51 Civil law jurisdictions specifically define the purpose of the purchase money security interest ('*privilège de prêteur de deniers*') as the security used to secure a loan contracted to finance the acquisition of real property paid for through the lender's monies made available to the borrower, such monies being secured by a lien over the property so financed. This type of security interest may be of relevance in the context of the acquisition of existing assets for a project.

12.52 The legal principles applicable to the purchase money security interest are very similar to those applicable to the conventional mortgage, except for specific points mentioned below.

12.53 A purchase money security interest can be considered to be a specific type of mortgage in favour of the lenders when the loan granted by the latter is used by the borrower to purchase specific real property. A purchase money security interest is, by law, first ranking and has an initial duration expiring two years after the last contractual payment date. The lien can only be granted up to the purchase price of

the real property financed out of the proceeds of the loan to be so secured. If excess moneys advanced need to be secured, a conventional mortgage would need to be granted to secure such excess.

Security over tangible moveable property

General provisions applicable to pledges of moveable tangible property

12.54 In civil law jurisdictions, all moveable tangible property may be subject to a pledge pursuant to the general provisions of the laws applicable to pledges of moveable tangible property unless specific statutes apply with regard to certain assets such as vehicles or machinery and equipment ('*nantissement de materiel et outillage*'). Most of the civil law jurisdictions, under the influence of the French civil code, provide that the pledged property must be held by the pledgee or a third party pledgeholder to create a valid and enforceable pledge. Dispossession of the pledgor is therefore required to create a valid pledge in the OHADA countries and Belgium and was also required in France, until the legal reform of March 2006.[5]

12.55 In the circumstances where moveable property is to be pledged, such as machinery and equipment necessary for the operation of the project, and dispossession cannot be implemented, a security interest over the equipment and machines would need to be implemented through a pledge over the project's business concern.[6]

12.56 Dispossession can, however, be facilitated through a third party pledgeholder acting as custodian without disturbing the operations of the project company. This type of mechanism is often implemented in respect of pledges of inventory, although the reform of the law in 2006 has introduced flexibility in this respect and dispossession of the pledgor is no longer a condition to the validity of a pledge over moveable tangible property. If the pledge is made without dispossession, such pledge must be registered with the registrar of the commercial court. A number of civil law jurisdictions based on the French civil code system have yet to introduce this flexibility.

12.57 A secured creditor benefits from a retention right ('*droit de rétention*') and a right to require from a court that the pledged property be transferred to him following foreclosure ('*droit d'attribution*'). The secured creditor also has the right to ask a court to order the sale of the pledged property.

[5] By ordinance n° 2006-346 dated 23 March 2006, France has implemented an important reform of the rules applicable to security interests and guarantees by, inter alia, introducing into its law the non-possessory pledge (perfection of which is made by registration of the pledge with a publicly available security registrar) or a special inventory pledge.

[6] See para. 12.31.

Pledge over machinery and equipment ('nantissement de materiel et outillage')

12.58 When machinery and equipment are not subject to a security interest through a pledge over a business concern (see paragraph 12.31) they may be subject to a pledge by separate written agreement governed by specific statutes.

12.59 The pledge over machinery and equipment ('*nantissement de materiel et outillage*') is a purchase money security interest that may be created only in favour of lenders to secure the loans made available to purchase the relevant pledged machinery or equipment. The pledgee does not have to take possession of the pledged machinery or equipment.

12.60 This type of security may be difficult to implement in complex project financings with several groups of lenders as it obliges the lenders to segregate a tranche of financing dedicated to the purchase of the machinery and equipment so that the pledge secures this specific tranche only. It may also raise intercreditor issues as not necessarily all lenders to the project would participate in this tranche and therefore cannot benefit from the security on a *pari passu* basis.

Security over intangible moveable property

12.61 The main security interests over intangible moveable property in civil law jurisdictions comprise security interests over claims, over intellectual property rights, and security interests over shares.

Security interests over revenues: pledge over claims and pledge over bank accounts

12.62 In non-recourse project financings, the lenders mainly rely on the future revenues of the project company and therefore seek to take security interests over those revenues. Control of the cashflows of the project company is considered by the lenders as one of the key elements of their collateral and is achieved by taking security over revenues, by controlling both the use of revenues and the making of distributions by the project company to the shareholders.

12.63 Depending on the nature of the project and the debtors of the project company generating the revenues, different type of security interest can be implemented.

Security interest over claims

12.64 Two security instruments governed by the French civil code are available to all types of creditors to secure all types of obligations. These security instruments have been generally implemented in all civil law jurisdictions: i.e. the pledge over claims and the '*délégation*' (a type of assignment of receivables).

12.65 A third security instrument was introduced in the early 1980s in France. It is known as the '*cession Dailly*' (Dailly assignment) of receivables by way of security, the use of which is restricted to credit institutions for the purposes of securing

credit transactions. This security instrument which is specific to the French legal system has no strict equivalent in any other civil law jurisdiction.[7]

12.66 As civil law jurisdictions do not recognize the floating charge concept, it should be noted that only identified or identifiable claims may be subject to a pledge or a *délégation*. Creditors may therefore take a security interest only over receivables, whether current or future, that arise under a contract existing at the time the security is granted.

Pledge over claims

12.67 In civil law jurisdictions, a pledge over claims generally needs to be evidenced either by an agreement executed before a notary or by an agreement registered with the tax authority and notified to the debtor by a bailiff ('*huissier*') or acknowledged by the debtor in an instrument before a notary.

12.68 This security is perceived as being impractical as a means to pledge receivables especially because of the cumbersome formalities and enforcement procedures applicable to it. For instance, such pledges often used to be subject to the prohibition of the '*pacte commissoire*' which prevents the secured creditor from enforcing the pledge without a prior court decision.[8] It used to be regarded by beneficiaries as more akin to a negative pledge, which would prevent the debtor from disposing of the receivables, rather than a security interest.

12.69 This security is also impracticable when the number of relevant receivables and related debtors does not allow the project parties to identify the claims or the debtors and/or to notify the debtors of the existence of the pledge. This would be the case, for instance, in telecom projects or in relation to motorway concessions.

12.70 Since the March 2006 law reform, the pledge over claims has become more attractive in France as the perfection formalities and the enforcement procedures have been simplified:

(1) to be perfected, the pledge merely needs to be notified to the debtor or acknowledged by it in a private deed;
(2) the pledge may be enforced either by application to the court for an order transferring the pledged receivables to the secured creditors ('*attribution judiciaire*') or by agreement with the pledgor on any other method of transfer of the pledged receivables; and
(3) discharge of the payment obligations in respect of pledged claims can be effected by payment to the pledgee.

[7] See para. 12.93.
[8] The '*pacte commissoire*' prohibition has largely been removed by the March 2006 law reform in France.

12.71 Although the March 2006 law reform has not been exactly replicated in other civil law jurisdictions, a number of these jurisdictions have implemented similar provisions.

Délégation

12.72 The '*délégation*' involves a person (the debtor) undertaking an obligation upon the instructions of another person (the assignor), in favour of a third person (the assignee). In other words, upon the instruction of a creditor, the debtor agrees and undertakes to pay its debt incurred *vis-à-vis* such creditor to a third party. The consent of all the parties to the '*délégation*' must be obtained but no specific formality is required. A delegation is a tripartite arrangement.

12.73 The '*délégation*' is binding against third parties when it is entered into (i.e. as from the signature by the parties of the agreement setting up such *délégation*). The consent of the debtor is the main advantage of the '*délégation*' as the debtor acknowledges that it is obliged to pay the assignee. No notification is therefore required. However, the consent of the debtor may render this security impracticable when the number of relevant receivables and related debtors does not allow the project parties to identify the debtors and/or procure their consent, as would be the case in telecom projects or with respect to motorway concessions.

12.74 There are generally two kinds of delegation: the perfect delegation ('*délégation parfaite*'), which constitutes a novation pursuant to which the assignee ('*délégataire*') has only a right of recourse against the debtor ('*délégué*'), and the imperfect delegation ('*délégation imparfaite*') which does not constitute a novation pursuant to which the assignee maintains a right of recourse against both the assignor ('*délégant*') and the debtor. The lenders will always ask for a '*délégation imparfaite*' to maintain its right of recourse against the project company.

12.75 Enforcement of a '*délégation*' does not require any specific enforcement procedure as the debtor undertakes *ab initio* to pay its debts directly to the assignee.

Security interest over bank accounts

12.76 When a pledge over claims or a '*délégation*' cannot be implemented for the reasons described above, for example as a result of the number of relevant receivables and related debtors, the alternative is to require the project company to have its revenues paid into one or several bank accounts pledged in favour of the lenders.

12.77 A pledge over a bank account in civil law jurisdictions actually constitutes a pledge over the balance standing to the credit of the bank account (current account) of the pledgor. This pledge does not technically relate to the cash itself, but rather to the contractual claim of the pledgor against the bank to recover the closing balance of its pledged bank account at the time the account is being closed. Such pledge is therefore governed by the provisions applicable to the pledge of claims described in paragraph 12.67 above.

12.78 The pledge of claims exists in most civil law jurisdictions following the French civil code legal tradition. It is however possible in certain countries, typically in Africa, that the pledge over bank accounts using the mechanism of the pledge of claims is unknown and therefore not used in practice. One of the reasons may be that the banks benefit in certain countries such as Algeria from a statutory banker's lien over the account and the amounts standing to the credit of the bank accounts opened in their books so that they do not need to create additional security. However, this account bank privilege raises issues *vis-à-vis* the other lenders participating in the financing of the relevant project.

Security interests over intellectual property rights

12.79 If intellectual property rights such as trademarks, licences, software, or patents are not subject to a security interest through the pledge over a business concern,[9] they may also be subject to a pledge by separate written agreement. The rules applicable to a pledge of intellectual property rights generally follow the rules applicable to the pledge of intangible assets. However, great care should be exercised in respect of the perfection formalities. In certain civil law jurisdictions such as France, registration of a pledge over intellectual property rights must be registered with a special intellectual property rights registrar.

Security interests over shares

12.80 Lenders customarily seek to perfect a security interest over the shares of the project company. The purpose of the pledge over the project company shares is twofold:

(1) it entitles the lenders to control the shareholding of the project company as the shares cannot be assigned to third parties without the consent of the beneficiaries of pledge; and
(2) as the case may be, it entitles the lenders to take over management of the project company more quickly rather than enforcing their rights under the security interests taken over the assets of the project company and under the direct agreements.

12.81 However, depending on the nature of the project company's shares, enforcement of a pledge over shares may be too slow to achieve due to certain cumbersome court procedures.

Rules relating to pledges over shares

12.82 Traditionally, the rules applicable to pledges over shares in most civil law jurisdictions following the French civil code legal tradition requires the pledgee to take possession of the relevant share certificates. This is because the shares were considered to be moveable assets represented by share certificates. Dispossession is achieved

[9] See para. 12.31.

by delivery of the share certificates to the beneficiaries of the pledge or to a third party acting as custodian. This regime is still applicable in numerous civil law jurisdictions following the French civilian code legal tradition in which shares are materialized by share certificates.

12.83 In contrast, when the shares are not represented by shares certificates, the rules governing pledges over intangible moveable property are applicable. These rules generally require that the pledge needs to be evidenced by either: (i) an agreement executed before a notary; (ii) an agreement registered with the registrar of a commercial court or any other registrar having jurisdiction; or (iii) with the tax authority and notified to the debtor by a bailiff ('*huissier*') or accepted by the debtor in an instrument executed before a notary.

12.84 It should also be noted that certain jurisdictions such as France have significantly amended the law applicable to securities by introducing the principle of dematerialization of securities ('*valeurs mobilières*') and specific rules applicable to the granting of security over the shares of a joint stock company (such as '*société anonyme*' or '*société par actions simplifiée*'). Pursuant to a reform implemented in 1981[10] all securities ('*valeurs mobilières*') issued in whatever form in France and subject to French law are required to be registered in an account held by the issuer or by a financial intermediary. The particular effect of this reform was to render dematerialization compulsory and definitive and to phase out physical share certificates. These shares are held in book entry form in an account either with the issuer or with a financial intermediary. The pledge over these shares is granted through a pledge of the securities account to which the shares are recorded. No formalities are required other than mere execution of a pledge declaration by the pledgor. A number of civil law jurisdictions following the French civil code tradition such as Luxembourg have implemented the EU Collateral Directive with its absence of formalism and simplified enforcement in a manner which is creditor friendly. France exercised a partial opt-out when implementing the EU Collateral Directive since it implemented the Directive to its fullest extent only in respect of derivative transactions.

The pledge entitles the lenders to control the shareholding of the project company

12.85 Throughout the life of the project and until enforcement of the pledge over the project company shares, the pledge mainly entitles the lenders to prevent a change of control in the shareholding of the project company. As a result of this security, the sponsors cannot dispose of the shares of the project company without the prior consent of the lenders.

12.86 The inalienability of the project company shares raises concerns for sponsors who usually wish to maintain the right to dispose of their interest in the project by reducing their stake in the share capital of the project company. The problem is

[10] Law n° 81-1160 of 30 December 1981, which became effective on 3 November 1984.

exacerbated when the sponsors comprise financial investors such as investment funds. As a matter of principle, financial investors often do not intend to maintain their interest in the project until the end of its term.

12.87 A change of shareholding raises two issues for the lenders:

(1) the new shareholders will need to satisfy the 'kyc' (know your customer) requirements of the lenders; and
(2) the lenders will have to release and re-execute a pledge over the shares which are assigned to the new shareholder.

12.88 Great care needs to be exercised to ensure that the lenders do not lose their first ranking security if for any reason there exist second ranking creditors. Lenders should also ensure that the new security, depending on the time of its granting, is not affected by, in the context of potential bankruptcy of the project company, possible preferences.

The enforcement procedure of the pledge may be cumbersome

12.89 Traditionally, the civil code provides that a creditor may not dispose of the pledged assets upon the occurrence of an event of default (prohibition of the '*pacte commissoire*'). Foreclosure over shares needs to be authorized by the court either through a public sale or by allocation by the court up to the value of the pledged shares as determined by an expert. These types of procedures are cumbersome and take time. They are therefore not always going to facilitate the lenders' ability expeditiously to take over the management of the project company.

12.90 The prohibition of the '*pacte commissoire*' has recently been removed from French law and the lenders are now entitled to use an alternative out-of-court enforcement process under which they can automatically be vested with title to property after an expert appraisal (the expert being appointed either by the court or the parties).

12.91 To mitigate the risks of this potentially lengthy enforcement procedure, lenders may seek to take security over the shares of an offshore intermediary holding company owned by the sponsors and holding the share capital of the project company. Such a holding company can of course be incorporated in a more creditor-friendly jurisdiction which would enable the lenders to take over the management of the direct and sole shareholder of the project company. This solution may also be tax efficient if the tax regime applicable to the transfer of shares of the project company penalizes the lenders.

Limitation of the security by way of transfer of title

12.92 Some civil law jurisdictions outside the EU have taken a restrictive approach in respect of the concept of transfer of title by way of security. Only a few exceptions have been implemented quite recently in France. Two have been implemented by law: (i) the assignment of receivables by way of transfer of title (the 'Dailly law

assignment') in 1981 and (ii) the trust or '*fiducie*' in 2007. The third one has been developed by practice: the cash pledge. The EU Collateral Directive has introduced on an EU-wide basis the concept of transfer of title by way of security.

Dailly assignment

12.93 Even though the Dailly assignment is specific to France, it is interesting to note how this security instrument has become key in the financing of certain projects, and especially the financing of PPPs.

12.94 The Dailly assignment provides for a simplified method of assignment of receivables which enables their assignments by way of security through the mere remittance to the assignee of a transfer form ('*bordereau*') signed by the assignor, describing the amount and type of receivables to be assigned.

Nature of the parties

12.95 The assignment of receivables can only be granted by a legal entity (whether public or private) or by an individual, but in the latter case only if acting in a professional capacity. The beneficiary can only be a credit institution ('*établissement de crédit*').

12.96 The beneficiary of a Dailly assignment must be a French licensed credit institution or a European credit institution benefiting from the 'European passport' which authorizes it to conduct banking activity in France.

Consideration

12.97 The Dailly assignment must be granted in consideration of a facility granted by the beneficiary to the assignor. There are two possible ways of implementing this requirement:

(1) the Dailly assignment may be granted by way of security for the obligations of the assignor towards the beneficiary under a loan or other credit facility; or
(2) the Dailly assignment may be granted as an absolute assignment, against the payment by the beneficiary of an acquisition price. This would effectively be the case in the context of a discounting facility, whereby a bank agrees to purchase receivables at a discount reflecting, in particular, the net present value of the receivables (this form of Dailly assignment is known as a '*cession escompte sans recours*').

The type of receivables

12.98 Any type of receivable can be assigned, whether against private or public debtors and regardless of the origin of the receivable. The assigned receivables can be existing, contingent, and/or future receivables provided that they are sufficiently identified.

Form of the assignment

12.99 The Dailly assignment is created by the remittance to the beneficiary of a transfer form ('*bordereau*') listing the assigned receivables. The transfer form is signed by the

assignor and dated by the beneficiary, upon which it takes effect between the parties and becomes binding against third parties.

Transferability

12.100 The transfer form may only be transferred by the beneficiary to another credit institution. It can be stipulated that the transfer will be effected by endorsement of the transfer form, but in such case, it is thought that the endorsement can only be made for full value, and not for part of the transfer form.

Effects of the Dailly assignment

12.101 The Dailly assignment operates so as to transfer title to the assigned receivables to the beneficiary as from the date on the transfer form, as well as all security interests, guarantees, and ancillary rights attached to each assigned receivable. As a result, the assignor cannot assign such receivables to any other person.

Notice of the Dailly assignment

12.102 Although the Dailly assignment is perfected by mere delivery of the transfer form to the beneficiary and dating of that form by the beneficiary, notice of that assignment may be given by the beneficiary at its discretion. In that case assigned payment obligations can only be discharged by payment to the beneficiary. Pending delivery of that notice, collection of payments is made by the assignor on behalf of the beneficiary who holds those payments for the account of the beneficiary.

Acknowledgement of the Dailly assignment

12.103 The debtor may be required (but is not obliged) formally to acknowledge the assignment. Following such acknowledgement, no defences can be raised by the debtor who is irrevocably committed to pay to the beneficiary unless the beneficiary knowingly acted to its detriment.

Application of the Dailly assignment in French PPPs

12.104 In 2004, the French legislature introduced a specific type of receivables assignment which applies to receivables with respect to the remuneration payable by a public authority which has awarded a project in consideration of the investment costs incurred under PPP contracts and in hospital projects.[11] This mechanism, based on the Dailly assignment, allows the conversion of part of a project financing into a quasi-public financing. As a result, it reduces the costs of the project as the interest rate margins applicable to this quasi-public financing are significantly below the margins applicable to equivalent financings bearing project risk.

[11] Order (*Ordonnance*) n° 2004-559, dated 17 June 2004, further amended by law n° 2008-735 dated 28 July 2008 and law n° 2009-179 dated 19 February 2009.

Conditions to be met

12.105 Where all or part of the remuneration payable by the public authority to the project company under a PPP contract is assigned by the project company by way of a Dailly assignment, the beneficiary of the assignment can seek to have it formally acknowledged by the public authority for up to 80 per cent of the value of the assignment, subject to the following requirements:

(1) the remuneration must be in respect of investment costs relating to the project, which include design and development costs, construction costs, ancillary expenses, interest during construction, and financing costs; and
(2) the acknowledgement must be conditional upon the public authority being satisfied that the investments have been made in accordance with the provisions of the PPP contract (including, in any event, completion of the works).

Effect of the acknowledged Dailly assignment in French PPPs

12.106 Following the completion of the works, the acknowledgement of the assignment of receivables becomes irrevocable and the public authority is unconditionally committed to pay the amounts owed by it to the project company directly to the beneficiary and can no longer raise any defences based on its relationship with the project company (such as the cancellation or termination of the PPP contract, or the defence of set-off).

12.107 The only defence which can be validly raised against the beneficiary is the four-year statute of limitation period with respect to the limitation applicable to receivables held against the State or other public authorities.

12.108 Accordingly, the risk of the project company becoming insolvent and the receivables being claimed by other creditors of the project company is set aside since the cash no longer flows through the project company. The credit risk is taken by the lenders, as beneficiaries of the Dailly assignment, on the credit of the public authority, rather than on that of the project company.

12.109 The project company remains, however, liable for the payment of all amounts due by it to the public authority pursuant to any breach of its contractual obligations or any penalties owed by it (for example, due to lack of performance or late performance).

Transfer of risk and margins

12.110 The lenders' take risk on the performance of the project company during the construction phase of the project. Upon completion of the works, the acknowledgement of the Dailly assignment becomes irrevocable and the assigned cashflows become isolated from performance risk, the lenders' risk thereby shifts from the project company to the public authority.

12.111 Where the assignment has been effected as a Dailly assignment by way of security, the lenders will have recourse against both the project company as borrower under the project facilities and the public authority pursuant to the acknowledged Dailly assignment.

12.112 It is possible that the lenders under an acknowledged Dailly assignment may agree that they are actually providing financing to a public body and that recourse will only be possible against the relevant public authority. They would therefore waive their rights of recourse against the project company. In such a case, the lenders can be regarded as being no longer a project lender but effectively a lender to the public authority.

12.113 Given that the risk is mitigated by an acknowledged Dailly assignment, the margin or interest rate payable following entry into force of the acknowledgement will usually decrease to reflect the new credit profile in line with the credit risk of the public authority. The costs of the project which are indirectly borne by the public authority are therefore decreased as it reduces the remuneration to be paid by the public authority to the project company under the PPP contract.

Cash collateral ('gage-espèces')

12.114 Cash collateral ('*gage-espèces*') is not governed by any specific provision of law. It has been developed by practice and its validity (at least when it is held directly by the pledgee) has been confirmed by case law in certain jurisdictions even though the characterization of cash collateral as a pledge, instead of a transfer of ownership, is subject to debate among legal scholars in France. Under this type of security interest, a fixed amount of cash is transferred to the pledgee and co-mingled with its general cash funds. Such cash may be transferred into an account opened in the name of the pledgee or in the name of a third party acting as custodian of the pledgee.

12.115 Since it relates to fungible assets which cannot be segregated from the rest of the secured party's assets, the cash collateral grants to the secured party the fiduciary ownership of the collateralized cash. Cash collateral can be used instead of a debt service reserve account, particularly when the amount to be cash collateralized does not change materially throughout the life of the financing. Debt service reserves in the form of cash collateral have been used in the financings of wind farms and photovoltaic power stations in the French market.

12.116 The cash collateral offers advantages from the perspective of enforcement. Indeed, because of the fungible nature of cash, the pledgee is vested with the ownership of the collateralized cash. Under those circumstances, in the event of a default of the pledgor, the pledgee is entitled to set-off the sums owed by the pledgor against the obligation to return cash held by the pledgee pursuant to the cash pledge. Exercise of the right of set-off requires, however, mutuality of obligations. Therefore, this

type of collateral may be impractical in the context of complex project financings involving several groups of lenders and multiple facilities.

12.117 Perfection of the cash collateral occurs upon transfer by the pledgor of the amount of the cash collateral to the account opened in the name of the pledgee or in the name of a third party acting as custodian of the pledgee.

12.118 It may not be possible to create and perfect this type of security developed in France in civil law jurisdictions other than France. The only alternative to taking a security over cash is to take a pledge over a blocked bank account.

Civil law fiducie (trust)

French fiducie

12.119 Under the Law of 19 February 2007,[12] France has adopted a *fiducie* regime designed to institute a mechanism making it possible to compete with the common law trust. Its introduction was the culmination of a debate in France over a period of almost thirty years. The regime has already been supplemented on several occasions mainly to widen its scope and clarify its effects in the event of insolvency proceedings.

12.120 The *fiducie* is a civil law tripartite contractual mechanism whereby a settlor transfers to a fiduciary the ownership of rights, assets, or security interests. The fiduciary then has the responsibility of administrating them in the interests of the beneficiaries and in accordance with the terms and conditions of the *fiducie* contract.

12.121 This tool has multiple applications for financing, asset management, and mergers and acquisitions.

12.122 The French *fiducie* has equivalents in other legal systems, particularly fiduciary alienation under German law and, to a certain extent, the trust in countries whose legal system is based on common law. But it is also based on a concept that is very specific to French civil law, the 'estate' (*patrimoine*), and more particularly the 'allocated estate' (*patrimoine d'affectation*).

12.123 Unlike a common law trust, there is no division of the ownership of the assets entrusted in *fiducie* between the legal ownership granted to the fiduciary and the economic ownership belonging to the *fiducie*'s beneficiary. However, the ownership transferred is of a contractual type. The French *fiducie* is also necessarily express, written, and consensual, whereas the common law trust can be implicit, unwritten, and unilateral. A settlor may not create a French *fiducie* without a deed signed by the fiduciary and without the beneficiary's acceptance.

[12] Law n° 2007-211 dated 19 February 2007 relating to the *fiducie*.

Application of the French fiducie to security

12.124 The *fiducie,* as introduced into French law, allows the creation of two possible security interests. First, it enables the transfer of assets and rights for the purpose of creating a security interest. Secondly, it is a tool that enables management of personal or real security interests by a fiduciary on behalf of creditors benefiting from such security interests.

12.125 Since the availability of mechanisms to create and perfect a security interest had previously been limited, the introduction of collateral *fiducie* has been enthusiastically welcomed in the French project finance market and elsewhere.

12.126 The *fiducie* represents a security interest mechanism that is both very effective from a lenders' perspective, should the debtor-settlors be subject to insolvency proceedings, and in that it provides significant flexibility.

Direct Agreements and Step in Rights

Rationale for direct agreements

12.127 In non-recourse project financings, the security interests of the lenders during the construction phase are limited and the lenders rely on the future fixtures and revenues of the project company as the core assets of the project company. To mitigate that risk and because the most valuable assets of a project company during the construction phase are its contractual rights to build and operate the project, direct agreements, which entitle the lenders to take over the contractual rights of the project company by transferring these rights for their own benefit or for the benefit of a third party designated by the lenders, have become customary.[13]

12.128 It is important to note that, as is the case in common law jurisdictions, under the civil law, the rights granted to the lenders under direct agreements are pure contractual undertakings. They do not create a security interest over the subcontracts or the rights arising thereunder in favour of the lenders. The efficacy of such a mechanism, especially in the context of bankruptcy of the project company, is also questionable.[14]

Direct agreements and stipulation pour autrui

12.129 In certain concession or PPP transactions in France, the public authority may refuse to enter into direct agreements with the lenders not because it refuses to grant step-in rights to the lenders but because the public authority considers that there

[13] See also para. 11.105.
[14] See para. 12.169 et seq.

exist other means to achieve the same purpose. Indeed, in the absence of direct agreements, step-in rights may be structured through the *stipulation pour autrui* mechanism provided for in the French civil code and which exists in most civil law countries.

12.130 The *stipulation pour autrui* is a civil law mechanism whereby an obligor (*promettant*) undertakes *vis-à-vis* a stipulating party (*stipulant*) to do or not to do something in favour of a third party beneficiary (*bénéficiaire*). An interesting feature of the *stipulation pour autrui* is that the beneficiary does not need to be a party to the agreement between the obligor and the stipulating party. The third party beneficiary only has to accept by a simple notification to the obligor that the *stipulation pour autrui* has been made in its favour.

12.131 Under a *stipulation pour autrui* provided for in a concession agreement or PPP contract, the public authority, as obligor, undertakes *vis-à-vis* the project company as the stipulating party in favour of the lenders, to transfer the concession agreement or PPP contract to any party designated by the lenders. The lenders then accept, by executing a separate letter, the *stipulation pour autrui*, which entitles them to enforce the step in rights.

12.132 The *stipulation pour autrui* mechanism is frequently used to organize the step in rights of the lenders if and when a public authority is reluctant to enter into a direct agreement with the lenders.

Issues Arising from Secured Lending

Early termination or cancellation of project contracts

12.133 In project financings of public infrastructure, one of the main concerns of the lenders is the impact of early termination of the underlying project contracts (for example, concession contracts, *Affermage*, PPP contracts, and, in projects where power is purchased by a state utility, power purchase agreements) since the lenders are financing the project on the basis of the projected cashflows to be generated until the expiry date of the relevant project contract. The lenders typically have limited rights over the assets of the project since the project assets either belong to the public authority from the inception of the project or have to be returned to the public authority upon termination of the project contracts. The other assets of the project have generally little value and are unlikely to be sufficient to provide full repayment to the lenders.

12.134 Therefore, the objective of the lenders is to ensure that the project company will be fully compensated and will receive an indemnity from the public authority covering at least the amounts outstanding under the financing in case of early termination of the relevant project contract.

Circumstances leading to the early termination or cancellation of the project contracts

12.135 Each of the following events occurring throughout the life of the project may lead to the early termination of the underlying project contracts.

Nullity of a project contract

12.136 Administrative contracts entered into between public authorities and the private sector have over the years resulted in significant amounts of litigation. The risk of litigation and subsequent nullity of a project contract has increased since the adoption in France of a regulatory framework on the awarding of public procurement contracts, the procedure of which must comply with general principles of freedom of access to public procurement, non-discrimination and equal treatment of bidders, publicity and transparency of procedures (see paragraph 12.13 et seq).

12.137 Recourse by third parties against the award decision of the public authority is therefore frequent and leaves a risk for the project which may lead to the cancellation of the relevant project contract and the related project.

Force Majeure

12.138 A *force majeure* event is a supervening event. *Force majeure* is traditionally defined in civil law jurisdictions as an event which is (i) beyond the control of either of the contracting parties to overcome ('*irresistible*'), (ii) unforeseeable ('*imprévisible*'), and (iii) not related to the contracting parties ('*extérieur aux parties*'). Upon the occurrence of a *force majeure* event, the parties are relieved from their obligations to perform the contract.

12.139 In France, the administrative courts have also developed the concept of administrative *force majeure* based on the general concept of *force majeure*. The administrative *force majeure* has the same facets as the general *force majeure* without the 'unavoidable' test. Indeed, the administrative courts consider that in certain circumstances, even if the event could be overcome, the event has resulted in a fundamental change to the equilibrium or the object of the contract.[15]

12.140 Project contracts generally provide that if a *force majeure* event occurs and is continuing for a determined period, either party has the right to require early termination of the relevant project contract.

12.141 The *force majeure* event in civil law countries is different from the theory of *Imprévision* and of *Sujétions Imprévues*. Under the *Imprévision* theory, if supervening

[15] In *Compagnie des Tramways de Cherbourg* (CE 9 December 1932) the concessionaire was on the verge of bankruptcy, but if the tram fares had been increased any more, the company would have lost its customers. The court decided that the object of the contract (to operate a tramway service at a reasonable price) had been negated.

circumstances have arisen after entering into a project contract for which no (or inadequate) provision has been made, leading to a deterioration of the private party's position and making it uneconomical to perform its part, the private party will not be allowed to terminate the contract but will have a right to compensation. The private party will be compelled to perform the project contract in question and will then be entitled to an indemnity from the public authority against its extra expenses. In the case of a concession, the indemnity may take the form of a right to increase the applicable tariffs for the services charged by the project company to the users of the services above the limits initially set forth in the relevant project contract.

12.142 Under French administrative law principles, *Sujétions Imprévues* are related to events or difficulties which have a material impact on construction, such as ground or climate risks. Unlike *force majeure*, *Sujétions Imprévues* do not excuse the project company from performing its contractual obligations but grant a right of compensation. In exceptional circumstances, *Sujétions Imprévues* may lead to the termination of a project contract, but only if it substantially changes the equilibrium of the relevant project contract.

Termination of a project contract in the public interest (résiliation pour motif d'intérêts général)

12.143 The rules on administrative contracts developed by French administrative law, as well as other civil law countries, have a number of differences in comparison with private law contracts. Those special rules mainly come from the predominance of the public interest, an interest which must prevail even to the extent of overruling the express terms of a project contract.

12.144 Therefore, the public authority entering into a concession agreement or a PPP contract with the private sector will always have the right unilaterally to decide at any time throughout the life of the project whether to require early termination of a project contract.

Termination of a contract by the public authority upon default of the project company

12.145 As in every contract, the public authority may also terminate a project contract due to the default of the project company. The events leading to the termination of a project contract must achieve a fair balance between the public authority's desire to be able to terminate a project contract for inadequate provision of service and the project company's and lenders' interest in limiting termination to substantial defaults when all other alternatives have been exhausted, including a reasonable grace period. In practice, the events of default leading to early termination will be limited to events such as:

(1) repeated breaches of the project contract which materially and adversely affect the performance of the service;

(2) winding up or bankruptcy of the co-contractor;
(3) abandonment of the project;
(4) failure to achieve completion by a pre-agreed completion date;
(5) accumulation of penalties;
(6) non-compliance with insurance requirements; and
(7) non-compliance with change of control provisions.

Indemnification of the project company and the rights of the lenders

Indemnification of the project company by the public authority

12.146 French administrative case law provides for general principles of indemnification arising from the losses incurred by the project company in case of early termination of a project contract. The amount of the compensation also depends on the cause of the termination.

12.147 Lenders and sponsors usually accept the principles developed under the relevant administrative case law to determine the compensation to be paid by the public authority to the project company in such circumstances. The sponsors and the lenders generally negotiate detailed indemnification provisions in each project contract to avoid uncertainties on the level of compensation and to ensure, as much as possible, that most of the costs will be indemnified.

12.148 In summary, the indemnification provisions in concessions or PPP contracts customarily provide for the following principles:

(1) *Early termination for project company's default*: The indemnification is traditionally based on the amounts due to the sponsors with respect to the equity and/or financing which they have provided and the amounts due to the lenders. This is reduced by an amount attributable to the loss incurred by the public authority. As a result, the indemnification is often lower than the amount outstanding under the lenders' financing so that the lenders remain at risk in case of early termination for project company's default. The inclusion in the indemnification of the breakage costs relating to the hedging arrangements entered into for the purpose of the project is usually subject to some negotiation among the lenders, the public authority and the sponsors.
(2) *Early termination for force majeure*: The indemnification covers the amounts due to the sponsors for their equity contribution and the amounts due to the lenders (including the breakage costs arising under the hedging arrangements) but excludes any loss of profit. It may also include the breakage costs arising under the commercial contracts which have been entered into by the project company.
(3) *Early termination for public interest*: The indemnification is traditionally equal to the indemnification arising in the case of early termination for *force majeure*, but increased to account for the loss of profit of the sponsors so that all parties

are entirely indemnified with respect to the losses they have incurred as a result of the early termination by the public authority in the public interest.

Hedging breakage costs in PPP contracts

12.149 Due to the long-term nature of PPP projects (from fifteen to forty years), the lenders do not have the capacity to make available such long-term facilities to the project company at a fixed interest rate mainly because the lenders cannot fund the facilities with deposits having the same maturity. The profile and the cost of the financing made available to the project company by the lenders to finance the investments made under PPP contracts are directly reflected in the remuneration profile paid by the public authority to the project company. However, for various reasons including budget constraints, the public authorities are reluctant to bear interest rate risks. A public authority will therefore usually require that the project company enter into interest rate swaps so that the portion of remuneration paid to the project company in consideration of the investments is fixed and not subject to floating rate variations.

12.150 The main issue with respect to the hedging arrangements relates to the breakage costs arising upon early termination of a project contract. The hedging banks will agree to enter into the required interest rate swaps provided that the costs incurred upon termination of the swaps are adequately covered either by the public authority or by the sponsors. As discussed in paragraph 12.148 above, most of the PPP contracts provide that the public authority will indemnify the breakage costs incurred by the project company upon early termination of a project contract. The indemnification provisions are included in the relevant project contract itself.

12.151 However, the indemnification provisions would not be effective if the early termination of a project contract results from its nullity following, for instance, recourse by third parties.

12.152 To mitigate this risk, the commitment of the hedging banks to enter into hedging arrangements is customarily contingent upon the expiry of the recourse periods during which a third party might challenge the validity of the PPP contract. In certain circumstances, the public authority may however insist on fixing the interest rates on the date of execution of the PPP contract or during a period of time starting from that date. To cover the risk of the PPP contract being nullified and the consequent invalidation of the indemnification provisions benefitting the hedging banks in a PPP contract, the hedging banks might be able to enter into a direct agreement with the public authority or seek a sponsor guarantee.

12.153 The validity of direct agreements (the purpose of which would be to ensure the survival of the indemnification provisions set forth in the relevant project contract) in the event a project contract is nullified is not free from doubt under French administrative law. Indeed, such an agreement would need to be a collateral contract (i.e. distinct from the relevant project contract) to avoid the nullification of

the latter resulting in the invalidity of the direct agreement. This matter has yet to be resolved in France and is still the subject of debate.

Insolvency of the project company and enforcement of security

12.154 The commencement of insolvency proceedings affecting the project company in civil law jurisdictions generally triggers an automatic stay of all actions by creditors subject to a few exceptions. The debtor is prohibited from paying any pre-filing claims arising before the insolvency proceedings and creditors are barred from enforcing their rights against the debtor including their rights under any security granted by the debtor. This means that pre-filing financial debts are immediately 'frozen'.

12.155 It is important to note also that the insolvency proceeding cannot per se accelerate pre-filing claims which have yet to mature, such as the bank or other debt made available to the project company (except in a judicial liquidation scenario where pre-bankruptcy claims are automatically accelerated). Any contractual clause to the contrary is usually deemed null and void.

12.156 As a matter of principle, the lenders are therefore not entitled to enforce the security granted by the project company, subject to a few exceptions.

12.157 Security granted by third parties such as sponsors or banks are, however, enforceable provided of course that the grantor or guarantor itself does not file for bankruptcy proceedings.

Security granted by the project company and direct agreements

Security interests with a retention right

12.158 Despite the fact that the lenders would not be entitled to enforce pledges granted by the project company following the commencement of insolvency proceedings (except in a liquidation scenario), a distinction can be made between pledges conferring a retention right and those which do not confer such right.

12.159 Indeed, during the insolvency proceedings, at the request of the administrator of the insolvency proceedings, the judge supervising the proceedings may exceptionally authorize the payment of a pre-filing creditor in order to procure that such secured creditor surrenders the retained pledged asset to the estate of the project company. This can be authorized only if the pledged asset retained by the secured creditor is deemed necessary to the debtor's continuation of its activity.

Security interests without a retention right

12.160 In relation to security interests without a retention right, if the pledged asset is sold by the administrator with the consent of the supervising judge, the sale proceeds are kept in escrow until the end of the proceedings and then allocated to the creditors depending on their respective rank/privileges. Secured creditors are traditionally

paid after creditors benefiting from a super-priority lien such as employees and the tax authorities.

12.161 In a liquidation scenario, creditors benefiting from a pledge are entitled to enforce their security interest.

Security by way of transfer of title

12.162 The main exception to the automatic stay arises in the context of security by way of transfer of title. As discussed in paragraph 12.92 et seq above, security by way of transfer of title is available within the limited scope of special statutes but offers a high degree of protection in the case of insolvency proceedings of the project company.

12.163 The use of the Dailly assignment in France, the cash transfer of title contemplated under the EU Collateral Directive and the trust put the lenders in a more favourable situation upon the bankruptcy of the project company.

Direct agreements and step in rights

12.164 As indicated above, the main purpose of direct agreements is to allow the lenders to appoint a replacement company or to assume themselves the responsibilities of the project company under the relevant project contracts by 'stepping into the shoes' of the project company if the latter is in default. The efficacy of direct agreements needs to be analysed from a bankruptcy law perspective as the project company may already be bankrupt when the lenders enforce their rights under the direct agreements or is likely to go into bankruptcy immediately after it is deprived of its contract rights.

12.165 Direct agreements are rooted in the Anglo-American legal tradition and are structured on the basis of insolvency laws applicable in jurisdictions following that legal tradition, which are often considered as more creditor friendly in comparison with the insolvency law applicable in civil law countries following the French civilian legal tradition.

12.166 For example, set forth below is an analysis under French law of the various obstacles to implementing step-in rights involving an insolvent French debtor. Direct agreements are designed to transfer the contract rights from the insolvent project company to a third party upon enforcement by the lenders and may be in conflict with the following mandatory principles of the French insolvency rules:

(1) the rule relating to the automatic stay of enforcement actions by creditors against the debtor;[16]
(2) the prohibition of the payment of pre-bankruptcy claims which are frozen;[17]
(3) the prohibition of the right to terminate ongoing contracts; and

[16] See para. 12.154 et seq.
[17] Ibid.

(4) the exclusive power granted to an administrator of the insolvency proceedings to assist in the management of the bankrupt company, and of the bankruptcy court to decide the outcome of the insolvency proceedings.

12.167 A purported substitution under a direct agreement may also be considered to violate the regulations governing the award of public procurement contracts.

Automatic stay and prohibition of payment of pre-bankruptcy claims

12.168 Even if the right of substitution under a direct agreement does not technically constitute a security interest nor a procedure to obtain accelerated payments from the debtor, the substitution may be characterized as a quasi-security. If courts characterize direct agreements as security, the exercise of the lenders rights under direct agreements would therefore be contrary to the principle of automatic stay of all enforcement actions against the debtor.

12.169 A question may also arise as to the compatibility of the substitution rights with the prohibition on making payments to pre-bankruptcy creditors. Indeed, if the substitution directly or indirectly enables the project company to reimburse the lenders, the rule prohibiting the payment of pre-bankruptcy claims may be violated since the lenders would receive their payments through the transfer of an asset of the project company.

Prohibition on termination of ongoing contracts

12.170 As a matter of principle, any ongoing contract should be performed in accordance with its initial terms and conditions notwithstanding any payment default existing at the time insolvency proceedings are commenced. The administrator of the insolvency proceedings is the sole person entitled to terminate any ongoing contracts whose execution is pending upon commencement of insolvency proceedings.

12.171 Therefore, co-contractors of the project company (such as the suppliers or the lenders) are barred from terminating the agreements entered into with the project company upon the sole occurrence of insolvency proceedings. Any clause to the contrary is likely to be deemed null and void.

Management and outcome of the insolvency proceedings

12.172 The administrator of the insolvency proceedings customarily has the exclusive power to assist the management of the insolvent company and the bankruptcy court and the exclusive power eventually to decide the outcome of the insolvency proceedings. The bankruptcy court is empowered to approve a restructuring plan or, if the continuation of the business is not possible, order the liquidation of the project company (i.e. sale of all or part of the assets).

12.173 The exercise of step-in rights by lenders could be deemed to be contrary to the rules governing insolvency proceedings relating to the administration of an insolvent

project company by the administrator and the bankruptcy court. This is because they would be hindered or prevented from controlling the sale or liquidation of the business, since key contracts would have automatically vested in the substituted entities.

Competition law

12.174 In respect of the step-in rights of the lenders relating to project contracts entered into with public authorities, the substitution entails a modification of the initial conditions of the concession or PPP contracts, consisting of a transfer of the rights and duties to another *concessionaire* or partner. Consequently, the issue is to determine whether the implementation of step-in rights amounts to a fundamental rewriting of the concession itself, thus rendering it necessary to comply with the obligations resulting from the regulations governing the award of public procurement contracts.

12.175 On the other hand, one could also argue that if the substitution entails the termination of a project contract, the new agreement should be entered into in strict compliance with applicable competition and procurement rules.

12.176 This issue, which is still subject to debate, should be carefully taken into consideration by the lenders at the time of enforcement of step-in rights.

Efficacy of direct agreements

12.177 Direct agreements indisputably raise many issues as to their validity and interface with the French bankruptcy rules. The Channel Tunnel case is a good example of the uncertainties relating to the validity of step-in rights. The Channel Tunnel concession was approved by the international Treaty of Canterbury between the French Republic and the United Kingdom on 12 February 1986. The Treaty of Canterbury was promulgated in France by an act of parliament of 14 June 1987 to approve 'in as much as necessary' the concession agreement. In 2004, when the Channel Tunnel concession company was on the verge of bankruptcy, the financial creditors envisaged exercising their step-in rights as stipulated in the concession agreement.

12.178 Despite the fact that the Channel Tunnel concession and the step-in rights provided for thereunder were approved by an international treaty and an internal law in France, the validity of the step-in rights was questioned. The consensual analysis concluded that the application of French domestic insolvency rules, even if they were to qualify as mandatory 'public policy' rules, could not be a valid obstacle to the implementation/enforcement by a French judge of the step-in rights only because they were approved by the Treaty of Canterbury and validated by the act of parliament of 15 June 1987.

Security granted by the sponsors

12.179 In non-recourse project financings, the financial obligations of the sponsors are traditionally limited to their obligation to contribute their equity stake in the project company. However, the sponsors:

(1) often grant a security interest over the project company's shares; and
(2) depending on the project and the risks identified by the lenders, may grant limited guarantees such as completion guarantees, performance guarantees, cost overrun guarantees or grant offshore cash collateral.

12.180 As a matter of French law, most of the security interests granted by the project company are likely to be frozen because of the automatic stay rule of enforcement actions by creditors against the debtor in a bankruptcy scenario of the project company.

12.181 Therefore, as a matter of principle, lenders would have immediate access only to the security or guarantees granted by the sponsors which should not, subject to exceptions depending on the relevant jurisdictions, be affected by a bankruptcy of the project company.

Influence of Civil Code in African Countries: Organisation pour l'Harmonisation en Afrique du Droit des Affaires (OHADA)

12.182 Project financing techniques have spread from France and elsewhere into many African countries, which have seen considerable development of their economies through the closing of project finance transactions in the mining, oil and gas, telecom, power, and infrastructure sectors. It is therefore important to have a thorough understanding of civil law jurisprudence when seeking to structure project financings in Francophone Africa.

12.183 In addition, in many African countries, it is also important to have a thorough understanding of the OHADA. This is the French acronym for '*Organisation pour l'Harmonisation du Droit des Affaires en Afrique*' translated in English as the 'Organization for the Harmonization of Business Law in Africa'. OHADA is an organization which was created on 17 October 1993 in Port Louis (Mauritius) and was formed by an international treaty.

12.184 Seventeen African states are now party to the OHADA treaty. Initially fourteen African countries signed the treaty, with two countries subsequently adhering to the treaty (Comoros and Guinea), and a third, the Democratic Republic of Congo, joining in 2010. However, the Treaty is open to all African countries, whether or not members of the Organization of African Unity (OAU).

Purpose of the OHADA

12.185 The objective of the OHADA is the harmonization of business laws in the contracting states by the elaboration and adoption of simple modern common rules adapted to their economies, by setting up appropriate judicial procedures, and by encouraging arbitration for the settlement of contractual disputes.

12.186 The origin of the OHADA was based on the wish of the OHADA nations to adopt a regime which would increase their attractiveness to foreign investment by materially changing the investment rules in West and Central Africa, with a view to enhancing local development.

12.187 For such purposes, the OHADA nations have agreed to give up some national sovereignty in order to establish a single, cross-border regime of uniform business laws. A particular feature of the OHADA laws is that they are immediately incorporated into the domestic laws of each OHADA nation. Therefore, the OHADA laws are somewhat comparable to EU regulations that become immediately enforceable as law in all EU member states simultaneously.

French civil law influence on the OHADA laws

12.188 Since most of the OHADA nations have been strongly influenced by the French civil code, the OHADA laws are based on the French legal system and are substantially influenced by the French-based laws that preceded them in most of the OHADA territories. The OHADA laws have, however, been adapted to the needs of these developing economies and updated.

12.189 It is also reasonable to assume that the French legal system will continue to influence new OHADA laws, at least to some degree, even if the member states of OHADA may have a keen interest in welcoming Anglophone African countries and their common-law heritage and to cherry-pick from various systems when drafting new laws, rather than to follow solely the French civil law tradition.

Structure of the OHADA organization

Member states of the OHADA

12.190 The uniform OHADA business law is applicable in 17 sub-Saharan African states : Benin (1995), Burkina Faso (1995), Cameroon (1996), Central Africa (1995), Comoros (1995), Congo (1999), Ivory Coast (1996), Gabon (1998), Guinea (2000), Guinea Bissau (1996), Equatorial Guinea (1999), Mali (1995), Niger (1995), Senegal (1995), Chad (1996), Togo (1996), and the Democratic Republic of Congo (2010).

12.191 Pursuant to article 53 of the OHADA treaty, any member state of the African Union may become a member, if it wishes to do so. Other African countries are giving active consideration to joining the OHADA common system of business laws.

OHADA institutions

12.192 The OHADA includes four institutions:

(1) the Council of Ministers of Justice and Finance, which is the organization's legislative body;
(2) the Common Court of Justice and Arbitration, based in Ivory Coast (Abidjan);
(3) the Permanent Secretariat, based in Cameroon (Yaounde); and
(4) the Regional Training School of the Judiciary, based in Benin (Porto Novo), administratively attached to the Permanent Secretariat.

12.193 The institutions of OHADA mean that the OHADA is not just a system of uniform laws, it is a unified legal system. It encompasses an entire legislative and judicial structure that formulates and interprets the OHADA laws and allows for their enforcement.

Council of Ministers of Justice and Finance—Uniform Acts

12.194 Acts enacted for the adoption of common rules by OHADA are known as 'Uniform Acts'. Uniform Acts are prepared by the Permanent Secretariat office in consultation with the governments of member states. They are to be debated and adopted by the Council of Ministers of Justice and Finance on consultation with the Common Court of Justice and Arbitration.

12.195 Adoption of the Uniform Acts requires unanimous approval of the representatives of the member states who are present and who have exercised their voting rights. Uniform Acts are directly applicable in the member states notwithstanding any conflict they may give rise to in respect of previous or subsequent enactment of laws by member states.

Common Court of Justice and Arbitration

12.196 Even though the OHADA laws provide for a harmonized set of rules throughout the member states, the OHADA laws would not be effective unless they are enforced without major variation between the member states. A harmonized enforcement mechanism is achieved because a law that OHADA adopts automatically and immediately becomes an internal law of each of OHADA's member states, coupled with the interpretive function of the Common Court of Justice and Arbitration ('*Cour Commune de Justice et d'Arbitrage*') which serves as the court of last resort for judgments rendered and arbitrations instituted within member states.

Regional Judiciary Training School of the Judiciary ('Ecole Régionale Supérieure de la Magistrature')

12.197 Another body that OHADA has established is a regional judiciary training school, the *Ecole Régionale Supérieure de la Magistrature*, which is designed to educate the legal professionals of the OHADA member states.

Content of the OHADA laws

12.198 The OHADA laws are purely business-related laws. These texts lay down the common rules governing business. The following uniform laws have already been adopted by the Council of Ministers:

(1) Uniform Act relating to general commercial law;
(2) Uniform Act relating to commercial companies and economic interest groups;
(3) Uniform Act relating to security (guarantees and collaterals);
(4) (iv) Uniform Act relating to simplified recovery procedures and measures of execution;
(5) Uniform Act relating to bankruptcy;
(6) Uniform Act relating to arbitration;
(7) Uniform Act relating to accounting law; and
(8) Uniform Act relating to law regulating contracts for the carriage of goods by road.

12.199 In the context of project finance and banking transactions, it is worth noting that the security interests governed by the Uniform Act relating to security include all the traditional French civil code security interests. The security interests developed more recently under French law and practice during the last thirty years (i.e. security interests over receivables by way of transfer of title, trust (*fiducie*), cash collateral, and pledges over securities accounts) still need to be implemented in the OHADA legal system.

12.200 The concept of a floating charge does not exist (except for the pledge over business concerns), nor does the concept of creating a security interest over receivables by way of transfer of title.

12.201 The Uniform Act relating to security governs the following types of security interest whose main terms and conditions are substantially based on the traditional methods of creating security interests under French law:

(1) the pledge over business concern;
(2) the pledge over moveable tangible property;
(3) the pledge over moveable intangible property;
(4) the pledge over shares;
(5) the pledge of inventory;
(6) the pledge of equipment; and
(7) the mortgage.

13

DEFAULTS AND WORKOUTS: RESTRUCTURING PROJECT FINANCINGS

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Introduction

What is a restructuring?

13.01 There is no specific legal definition of a restructuring (also referred to as, amongst other things, a workout, turnaround, or corporate rescue) and it is a term which is used to cover a number of transactions ranging from a solvent covenant reset through to a fundamental balance sheet restructuring, often in the form of a debt for equity swap, whereby the existing equity in an entity is taken over by its creditors

in consideration for the partial or complete release of those creditors' debt claims. As a general statement, however, a restructuring is a reference to a process by which a company which is experiencing, or which will imminently experience, financial difficulties, negotiates an amendment or rescheduling of its financial obligations in order to avoid a liquidation or other form of 'terminal' insolvency and thereby continue as a going concern. A restructuring therefore attempts to match a company's financial obligations to its actual performance.

13.02 The economic rationale for a restructuring is clear: formal insolvency is likely to be value destructive for all stakeholders and therefore each stakeholder is likely to be better served by a restructuring which seeks to preserve the economic value of a company, albeit on different terms from that bargained for when the company was originally financed. This assumes of course that the entity to be restructured has inherent value, i.e. companies which are successfully restructured tend to have a good underlying business but an inappropriate balance sheet for the size and prospects of that business going forward. Bad balance sheets can be dealt with by a restructuring; fundamentally bad businesses cannot.

13.03 Restructurings can take place either on a fully consensual, out-of-court basis (i.e. freely negotiated and agreed by all relevant stakeholders) or can be implemented on a non-consensual basis (where not all stakeholders agree with the particular restructuring being proposed). Where a restructuring is implemented on a non-consensual basis it will usually be done so using some form of formal, court-supervised insolvency or 'cram-down' process in the relevant jurisdiction or jurisdictions in order forcibly to bind or disenfranchise the dissenting stakeholder(s). The insolvency process in such a case is not, however, a terminal process as its purpose will be to enable the company to continue to operate and trade on a restructured basis as opposed to it being the process by which the company is wound down and ceases to exist.

What is different about a project finance restructuring?

13.04 Whilst project finance restructurings share much in common with their corporate brethren they can also differ in significant ways as a result of the particular, highly structured features of a typical project finance transaction. Project finance depends on a fundamental alignment of the debt and equity financing arrangements with the terms of the project's underlying commercial contracts. Project finance is one of the few practice areas of financial law where finance lawyers are required to delve deep into the underlying commercial contracts of the business being financed. As a result, whereas many corporate restructurings can be classified as purely financial restructurings (i.e. affecting only financial creditors, whilst the debtor's underlying commercial and trading contracts and relationships are unaffected), project finance restructurings often involve not only a financial restructuring to resize and/or amend the terms of the project company's debt, but may also involve

a restructuring of the key commercial contracts upon which its business depends. This can make a project finance restructuring even more complex and time-consuming than the restructuring of a non-project entity.

13.05 This being said, for the reasons explained in paragraph 13.94 below, the options available to creditors in a project finance restructuring are frequently more limited than those available to creditors in a corporate restructuring and, consequently, the fundamental balance sheet and 'loan-to-own'[1] restructurings which have been a feature of a number of recent leveraged finance restructurings are less common (although not unknown) in project financings.

13.06 With the above in mind, the purpose of this chapter is to provide the non-restructuring specialist reader with a general overview of the protagonists in a restructuring, their motivations and options, together with an overview of the restructuring process, noting, where relevant, the particular features of project financing which have an impact on these matters as compared with a 'standard', corporate restructuring. The references throughout to the 'debtor' or 'company' are references to, in a project finance context, the project company.

Why do projects need restructuring?

13.07 As explored in Chapters 4 and 5, project finance depends fundamentally on risk identification and the mitigation and allocation of those risks amongst the various project stakeholders. Project risks are numerous and varied and include construction costs, timing and completion risk, third party performance risk, political and regulatory risk, and market risk. The manifestation of these risks and the subsequent financial difficulties that they entail can occur during any stage of a typical project's life cycle: development, construction, or operation.

13.08 Projects, like other corporates, are vulnerable to a number of risks which challenge the economic assumptions upon which their financing was arranged, for example, mismanagement, the insolvency of key customers or suppliers and, more generally, changes in the macro economic climate. In addition, as projects are, by their very definition, single purpose, non-diversified undertakings, projects are particularly vulnerable to unexpected changes in the particular market which they operate and/or unrealistic assumptions about the market on which the original financing was prefaced. A good example of the impact of changes in particular market conditions was the significant fall in prices (up to 40 per cent) in the UK wholesale electricity market between 1998 and 2002 which led to several high-profile restructurings in

[1] 'Loan-to-own' is a reference to a strategy, generally pursued by a number of specialised hedge funds/opportunity funds, whereby investors purchase the debt in a financially distressed enterprise at a significant discount, with the specific aim of implementing a fundamental balance sheet restructuring whereby some or all of that debt is converted into equity in the restructured company.

the energy sector, for example, the 2003 restructuring of Drax, the UK's largest coal-fired power station. For a relatively recent example of the effect of unsustainable market assumptions, the original financing for the Lane Cove Tunnel project in Sydney was based on an assumption that traffic usage would range from 90,000 to 110,000 car trips a day. In reality, an initial toll-free period resulted in 75,000 car trips a day and, following the introduction of a toll, 50,000 trips a day.[2] It is unsurprising therefore that the original project company which owned and operated the tunnel subsequently went into receivership.

13.09 Notwithstanding the inherent riskiness of single purpose, non-recourse project financings, it is notable, by reference to the financial and liquidity crisis of 2008–2009, that project finance transactions have, in the main, remained relatively immune to the need for the fundamental restructurings that have been seen in other product areas such as leveraged finance and CMBS transactions. This is perhaps testament to the thoroughness of the downside risk assessment of project financings (a virtue of their inherent riskiness) and the highly structured manner in which risks are identified and, to the greatest extent possible, isolated and mitigated. Not only does this mean that default rates are lower but, generally speaking, even following a default, recovery rates on project financings have historically tended to be higher than on other forms of leveraged and general corporate financing.[3] It is because of these fundamental structural features that project finance, although premised on high leverage levels, tends to have much lower margins than in the corporate leveraged market.

Restructuring Protagonists

Overview

13.10 The outcome of any particular restructuring will be determined, in large part, by four key factors:

(1) the prevailing economic and financial circumstances at the time of the restructuring;
(2) the causes and extent of the company's financial difficulties;
(3) the identity of the protagonists and their economic motivations; and

[2] Cited in Geoff Phillips, 'Analysis of Sydney Public-Private Partnership Road Tunnels', Paper for ASOR National Conference, 3–5 December 2007, available at <http://www.maths.usyd.edu.au/u/geoffp/melfinrv.pdf>.

[3] See, for example, Standard Poor's, 'Project Finance Consortium Study Reveals Credit Performance Trends Since the Early 1990s', 8 August 2007 (available at <http://www2.standardandpoors.com/spf/pdf/products/ProjectFinanceConsortiumStudy_09_26.pdf>).

(4) the protagonists' legal rights and obligations under both their existing contractual arrangements and as a matter of the general law in the relevant jurisdiction(s).[4]

13.11 Perhaps more than any other area of financial law it is this fourth element which makes restructuring such a fascinating practice area as the ultimate 'backdrop' to any restructuring will be the insolvency alternative (i.e. what would be the result if a restructuring is not concluded and the entity in question is liquidated/wound-up). In the words of Philip Wood:

> Insolvency law is the root of commercial and financial law because it obliges the law to choose. There is not enough money to go round and so the law must choose who to pay. The choice cannot be avoided, compromised or fudged. On insolvency, commercial law is at its most ruthless: it must decide who is to bear the risk so that there is always a winner and a loser, a victor and a victim. On bankruptcy it is difficult to split the difference. That is why bankruptcy is the most crucial indicator of the attitudes of a legal system in its commercial aspects and arguably the most important of all commercial legal disciplines.[5]

13.12 The harsh reality of the 'zero-sum' nature of insolvency as described above means that each protagonist's economic motivations and aspirations in a restructuring will need to be tempered by their legitimate expectations of what will happen if the restructuring fails and a terminal insolvency is the result. Restructurings can therefore often resemble a very complicated game of poker as the various protagonists attempt to second guess each other stakeholder's 'hand' by reference to their rights on paper and their inclination and ability to exercise those rights in practice. Understanding the motivations of each participant is key to achieving a successful restructuring.

13.13 Whilst the identity of the protagonists, their motivations and their legal rights and obligations will obviously differ in each particular case, it is instructive to summarize (by way of a generalization) the key protagonists in a restructuring and some of the legal issues, options, and motivations which will be relevant to them, with reference to the specific features of project finance.

The debtor and its directors

13.14 The debtor (i.e. the project company in the case of a project financing) will be at the centre of the restructuring. Central to what the debtor does will be the actions of its directors and those actions will be determined in large part by the requirements of

[4] Different jurisdictions take very different approaches to how creditors' and borrowers' rights are affected on an insolvency. The nature of the legal regime in the jurisdiction in which the debtor would undergo an insolvency will therefore be key. The specific cross-border issues relating to the recognition of insolvency proceedings across borders and the exceptions to that recognition in each jurisdiction in which the debtor may have assets is, however, beyond the scope of this chapter.

[5] Philip Wood, *Principles of International Insolvency* (2nd edn, Sweet & Maxwell, London 2007) p. 3.

the law relating to directors' duties in the relevant jurisdiction(s). These duties can be central to the outcome of any restructuring and can fundamentally dictate the timing and form of a restructuring. Any restructuring stakeholder is therefore well advised to understand at the outset what these duties may entail. As director liability in many jurisdictions will entail personal financial liability and, in some jurisdictions, criminal liability for the directors in question, the issue tends to focus directors' minds beyond mere commercial expediency.

13.15 The example which is often given with respect to different jurisdictions' approach to directors' duties and the impact this can have on a restructuring is the contrast between the wrongful trading regimes under English and German law. Under English law, a director will potentially be liable for wrongful trading if 'at some time before the commencement of the winding up of the company, that [director] knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation'.[6] It is a defence to a claim for wrongful trading if, after the director knew or should have concluded that there was no reasonable prospect of avoiding an insolvent winding up, the director took every step with a view to minimizing the potential loss to the company's creditors as he ought to have taken.[7]

13.16 The impact of the wrongful trading regime in England is that, generally, it allows directors to continue to trade when facing financial difficulties provided that there is a reasonable prospect that restructuring negotiations will successfully conclude (even if in fact they do not). This therefore gives time for the relevant financial and business information to be produced and analysed, restructuring proposals to be formulated and restructuring negotiations to occur without the directors feeling compelled to file the debtor for insolvency for fear of their own personal liability.

13.17 The position under English law contrasts with the position in Germany where directors of German debtors face criminal sanctions if they fail to file the debtor for insolvency within twenty-one days of actual knowledge of the company's insolvency, measured on a cashflow (illiquidity) and/or balance sheet (overindebtedness) basis. The three-week 'grace' period, however, is not available if, and to the extent that, prior to the expiry of the period, it becomes apparent that the insolvency grounds (i.e. illiquidity and/or overindebtedness) cannot be cured within that period. The impact of this regime is that it can give German companies much less time to arrange a restructuring than that afforded to English companies.

13.18 Whilst a restructuring is rarely an event which any of the main protagonists will particularly enjoy (it is, after all, not something that people, other than those who make a living from investing in, or advising, financially distressed companies,

[6] Section 214(2)(b) of the Insolvency Act 1986.
[7] Section 214(3) of the Insolvency Act 1986.

voluntarily embark upon), the position of the directors can often be the most stressful. The Chairman of the English casinos company, Gala Coral, which underwent a significant restructuring in 2010, put it as follows:

> It's been the year from hell. I'm going to write a book about it. At one stage, the mezzanine lenders accused me of being in the pocket of the private equity players. The senior lenders accused me of being a mezzanine poodle. And my private equity players accused me of being too close to the senior lenders. . . . My view on that was I had to be doing it about right because everyone seemed to hate me.[8]

13.19 The position for directors of a project company who are also employees of the sponsors (which is often the case) can be particularly fraught. Even though their legal duties will be relatively clear (i.e. as the company enters into the 'twilight zone' of financial distress, the focus of their duties shifts from the shareholders (as the embodiment of the company's interests) to the creditors of the company), their role as an employee of a sponsor will inevitably complicate their position in practice. It is not unusual for directors to obtain legal advice for themselves separately from their company in a restructuring.

13.20 Whilst for some creditors playing 'hardball' with existing management/directors will be part of their *modus operandi* in restructuring negotiations, ultimately the process is unlikely to be helped if a genuine attempt is not made to keep the directors 'on-side'. They will, after all, likely know the business better than anyone else and, whilst not always the case, existing management (or certain individuals within the existing management) may be fundamental to the likelihood of successfully executing the revised business plan upon which any restructuring will be based.

The financial creditors

13.21 The financing parties' obvious motivation in any restructuring will be to protect the value of their investment. Behind this statement of the obvious, however, is the reality that in complex, multi-creditor structures (on which project financings are often based), it is very rare that creditors will act as a homogenous group during a restructuring. Different financial creditors will have different priorities and motivations depending on a number of variables, for example, whether they are an original par investor or a distressed secondary market purchaser, where their debt ranks in any intercreditor arrangement, what price the debt is 'marked' at for their own internal reporting purposes, and the nature of the debt held (for example, bank or bond debt).

13.22 In a project finance context, other points of difference between creditors can include different approaches from bridge lenders who finance the construction of the project but who otherwise expect to be refinanced on or prior to the project's commencement of operations and the project's longer-term investors.

[8] Neil Goulden (Executive Chairman, Gala Coral), quoted in *The Guardian*, 'Gala Coral Chief Executive Dominic Harrison to Quit', 21 July 2010.

Commercial banks can also often have a very different approach to a project finance restructuring when compared with the development/export credit agencies, which often, together with the commercial banks, participate in cross-border project finance transactions.

13.23 As a general rule, it will be the senior creditors (often represented through a committee of the largest creditors—see paragraphs 13.46–13.50 below) who will be largely responsible for devising, in conjunction with the debtor, a restructuring proposal and then 'selling' that proposal to other stakeholders and implementing it. However, even amongst senior creditors there can be a divergence of interests. This divergence of interests will broadly be between those who may have opportunistically bought into the senior debt at a discount and who may be motivated to agitate for a fundamental balance sheet restructuring (with a concomitant permanent 'haircut' on the debt outstanding) and those original par creditors whose motivation may be simply to renegotiate covenants with a borrower and thereby avoid having to report a non-performing asset on their books.

13.24 The emergence in the past ten to fifteen years of specialized distressed debt investors has undoubtedly had a profound impact on the manner in which restructurings are conducted and the form they take. These investors are highly specialist and will look across a company's entire capital structure for opportunities to profit from a restructuring; usually they will be focused on exploiting a position as a 'fulcrum' creditor (see paragraph 13.75 below for a discussion of 'fulcrum' creditors). The common characterization of such investors as 'vultures' is often unfair. Whilst their presence can complicate restructurings, they can be a source of vital liquidity for banks to manage their positions and can help develop innovative restructuring solutions as well as sometimes being prepared to provide new money to distressed entities.

13.25 In an attempt to regulate the competing agendas of different creditors during complex multi-creditor workouts, INSOL International has promulgated a set of principles[9] which are designed to reflect a best-practice approach by creditors and debtors to achieve a successful restructuring. There are eight principles in total and they revolve around the application of three fundamental concepts during the restructuring period:

(1) creditors should not take action to reduce their exposure (for example, by cancelling facilities that would otherwise be available);

[9] INSOL International, 'Statement of Principles for a Global Approach to Multi-Creditor Workouts', October 2000. Available at <http://www.insol.org/pdf/Lenders.pdf>. INSOL International is a worldwide federation of national associations for accountants and lawyers who specialise in turnaround and insolvency.

(2) borrowers should not take action which would adversely impact on a creditor's return; and
(3) if any new money is advanced to the debtor, it should be granted priority status.

13.26 While the principles obviously have no force of law they are sound guidelines for the conduct of a restructuring, particularly in multi-jurisdictional, multi-facility situations. In practice, however, it is not uncommon to find the principles quoted selectively and paid no more than lip-service by some stakeholders.

The sponsors

13.27 The sponsors are, for obvious reasons, central to any restructuring. They will have provided a significant amount of the original financing for the deal (albeit subordinated to the creditors' claims) and will also often have, particularly in a project finance context, the expertise and specialized, technical personnel necessary for a project's successful development and/or operation.

13.28 In addition, whilst project finance is in theory fundamentally structured on a 'non-recourse' or 'limited recourse' basis, meaning that the financial creditors in a project financing will usually have no or limited recourse to the sponsors of the project, in practice sponsors often retain some residual 'credit support' liability to the project's financial creditors. For example, some form of contingent equity support may have been provided when the transaction was originally financed to mitigate the risk of cost overruns during the construction phase of the project. Sponsors sometimes also provide a completion guarantee whereby they agree to guarantee the completion of the construction of the project and/or the repayment of the senior debt during the construction phase of the project or provide a more limited guarantee relating to specific risks. Depending on the timing of a project's financial distress, this residual liability will obviously focus the sponsors' minds because if the project fails and this residual liability is called upon, their loss will exceed their original equity investment.

13.29 In a project finance context, the significance of the sponsors in a restructuring often exceeds the (important) fact that they have provided a portion of the original financing. This is because they often 'wear another hat' in that their original equity investment in the project will often be allied with the provision of core construction, operations, or maintenance services to the project or as an offtaker or marketer of the project's product. This can complicate the bargaining dynamic between debt and equity in a restructuring and can give the sponsors additional leverage that they may not otherwise have in, for example, a leveraged finance restructuring.

13.30 Creditors generally recognize that they are in the business of lending money, not running complex projects, and therefore will usually place a premium on having a borrower (through its sponsors) which is experienced in the industry in question as

it will generally be in the best position to keep the project afloat and improve the project's financial position.

13.31 For all these reasons, the bargaining dynamic between debt and equity in a project finance restructuring will be absolutely key to its outcome. The approach of the sponsors to a restructuring will be largely driven by their expected financial return on a project; their willingness to commit any new funds which may be required as part of a restructuring will principally be determined by their own internal rate of return objectives and requirements.

The project parties

13.32 Whilst the dynamics and risk sharing between debt and equity are common to any form of financial restructuring, what can make project financing restructuring different is that, as noted in paragraph 13.04 above, the underlying project contracts may need restructuring as well. Where this is the case, the parties to those contracts will also be key players in any restructuring. This contrasts with, for example, a restructuring of a corporate leveraged finance transaction where trade creditors, suppliers, and customers are, whilst interested observers in the process (if it takes place in the public domain), unlikely to be key players in what will usually be solely a financial restructuring, often implemented at a holding company level and therefore removed from the day-to-day operations of the underlying business.[10]

13.33 The original project contracts, be they the long-term supply contracts, the construction contracts, or the offtake contracts, will have been scrutinized in considerable detail when the original deal was put together and, fundamental to that scrutiny, will have been the identification and allocation of risks amongst all the interested parties. A restructuring will very often mean a restructuring of the risk allocation upon which the original transaction was based not only as between the providers of the project's finance but also as between the other key project parties such as offtakers, construction contractors, and project operators.

13.34 The ability of a project company successfully to restructure will depend on the willingness of the various project counterparties to engage in such a restructuring. Where, as is often the case, the relevant project party is connected to the project company (as noted above, sponsors often provide key construction, operation, or maintenance services to a project or otherwise purchase or market its products), it is likely to be incentivized to be cooperative in the restructuring process in order to ensure the continued viability of the project. In the case of a non-connected party, their willingness to cooperate will be purely based on a commercial assessment of their interests as a third party although the fact that they are likely to be an unsecured

[10] There are notable exceptions to this. For example, in the corporate restructurings of several car parts manufacturers and suppliers in recent years, the involvement of, and financing from, the global vehicle manufacturers has been crucial.

creditor of a project company, and their returns on any unsecured claim are likely to be negligible if the project fails, means that they will frequently be prepared to compromise to make a restructuring work. Unless, that is, they have a contract which is 'out of money' in which case their motivation may be just the opposite.

The government/local authorities

13.35 Politics can be a crucial aspect in project restructurings. As projects are often based on state granted concessions this will give the relevant public authorities a direct, vested interest in any restructuring, particularly bearing in mind the conditions that may have been attached to such a concession. In addition, as project financings often concern critical infrastructure projects, even where the state, in whatever guise, does not have a direct method of influence, there may well still be political considerations for project restructurings which would be absent in the course of a normal, corporate restructuring. This is coupled with the fact that a number of jurisdictions have specially designed insolvency procedures for certain types of public/private project companies. For example, Metronet, one of the project companies formed in the UK with respect to the high-profile and controversial public-private partnership (PPP) for the maintenance and upgrade of the London Underground network, was in July 2007 placed into the special PPP administration procedure provided for in the Greater London Authority Act 1999.[11]

Other parties

13.36 Depending on the type of project and the manner it which it was financed, a number of other parties may be relevant. For example, a number of project financings have been financed in the past by 'wrapped' bond issues. This refers to project bonds which benefit from a guarantee given by one of the monoline insurers. MBIA was a crucial player in the Eurotunnel restructuring[12] as it had given a guarantee for a large number of the bonds issued in connection with the Eurotunnel project and therefore bore the largest credit exposure during the restructuring of that entity. MBIA also featured in respect of the attempted restructuring of the Lane Cove Tunnel in Sydney (referred to above) as it had also provided a 'wrapped' bond guarantee in respect of the bonds used to finance the original development and construction of the tunnel.

[11] Whereas the interests of the creditors as a whole lie at the heart of the purpose of a normal administration under English law, the purpose of a PPP administration differs from this in that primacy is given to continuing the services provided under the relevant PPP agreement. This has to be balanced against the duty of the PPP administrators to protect the interests of creditors.

[12] For a summary of the Eurotunnel restructuring, one of the largest project finance restructurings in history and often referred to as one of the most complex restructurings to ever to have been completed, see the INSOL International publication 'Eurotunnel plc and Eurotunnel S.A. and Associated Companies: 2 August 2006 and 15 January 2007', Case Study—1 November 2008, available at <http://www.rovigo.ro/images/INSOLInternationalTechnicalCaseStudy1.pdf>.

Process

Introduction

13.37 Each restructuring will have its own process-related idiosyncrasies but as a broad generalization it will follow these five chronological, process categories/stages (although with some inevitable timing overlap between them):

(1) the occurrence of a restructuring 'trigger';
(2) creditor organization and information gathering;
(3) standstill negotiations and formalization;
(4) restructuring negotiations and proposals; and
(5) restructuring implementation.

The restructuring 'trigger'

13.38 To state the obvious, a restructuring requires the debtor to engage and unless the creditors have some form of contractual leverage, a debtor and/or its owners are unlikely to be willing to do so. The contractual 'trigger' that enables financial creditors to force the process is usually the occurrence of an event of default or potential event of default under the relevant finance documentation.

13.39 Prior to the occurrence of an unambiguous event of default (for example, the breach of a financial covenant), there can occur an uneasy stand-off between the debtor/the sponsors and creditors. The creditors, knowing that the company faces difficulties, will be combing the documents for potential leverage, whilst the debtor will usually tread very carefully, often seeking to delay the trigger and, usually, loathe to admit readily to the occurrence of an event of default. Even in circumstances where the debtor wants to be proactive, the relevant credit documentation can often provide that the very act of approaching creditors generally, or a group of creditors specifically, with a view to discussing debt re-scheduling can, *per se*, be an event of default.[13] Debtors will be very wary of the cross-default implications of such a provision in their financing documentation even if they are minded to make a proactive approach to creditors.

13.40 In addition, in a project finance context, as the occurrence of an event of default will likely have certain automatic consequences on, for example, the movement of cash under the accounts agreement (as referred to at paragraph 13.98 below) combined with the fact that the absence of an event of default will be a condition to, for

[13] The Loan Market Association standard form credit agreement provides that it is an Event of Default if the relevant entity 'is unable or admits inability to pay its debts as they fall due, suspends making payments on any of its debts or, *by reason of actual or anticipated financial difficulties, commences negotiations with one or more of its creditors with a view to rescheduling any of its indebtedness*' (emphasis added).

example, the release of any contingent equity support provided by the sponsors at the end of the construction phase of a project, the borrower and the sponsors may go out of their way to delay the occurrence of an event of default if at all possible.

13.41 Immediately upon the occurrence of an event of default, it is highly advisable, even if the creditors have no immediate intention of exercising any of the rights which may accrue to them as a result of that event of default occurring, to write to the company formally reserving all rights to ensure that the debtor is not able subsequently to argue that there has been an implied waiver of rights. This formal notice of an event of default will also have the virtue of unambiguously starting any 'cure' periods which may operate with respect to potential or actual events of default which can otherwise be cured within a certain period of time under the relevant finance documents.[14]

Project finance covenants

13.42 The timing and nature of the event of default which will act as the restructuring 'trigger' will depend fundamentally on the covenants which were negotiated as part of the original financing. As explained in previous chapters, project financings are highly structured, principally because the financial creditors' prospects of repayment will depend solely on the revenue stream from the asset being financed which, more often than not, will not start generating theses revenues until some years after the creditors make available the bulk of the funds to finance the project. As a result, project finance documentation tends to contain numerous covenants and restrictions to provide financiers with protections and early warning signs of potential problems with the project's underlying economic assumptions. Well-designed project finance documentation will contain a plethora of reporting requirements, the 'intrusiveness' of which would make an ordinary corporate borrower wince. These requirements should allow the project's financial creditors continually to test the validity of the underlying economic assumptions against the actuality of the project's development and performance, thereby giving the creditors the ability to intervene at an early stage should the project run into problems.

The impact of covenant 'loosening'

13.43 Notwithstanding the extensiveness and 'intrusiveness' of project finance covenants as compared with other forms of financing, during the heady years of the 'great moderation' and the ensuing liquidity in the credit markets which reached a peak in 2007, the project finance market was no less immune to the loosening of covenants that occurred in the leveraged and other financing markets as banks competed

[14] Cure periods are often expressed to run from the time the debtor actually became aware of the relevant event of default or from the day upon which the debtor received notice of the occurrence of an event of default from the creditors' agent/trustee.

on a lowest common denominator basis for financing mandates. The result of this is that a large amount of the project financing arranged in the period between 2004 and 2007 was done on 'looser' terms than has historically been the case. This loosening permitted, amongst other things, higher leverage ratios, lower debt service coverage ratios, and, generally, less strict reporting requirements. As a result, the ability of creditors to intervene early has been restricted and, even when they are able to, the result of permitting much higher leverage ratios is that the creditors' equity protection (i.e. the amount of the 'first loss' financing provided by the sponsors) is much less than it has been in the past, so on an enforcement and sale following an event of default, lenders are more likely to suffer a loss on their debt.

Material adverse change 'triggers'

13.44 As stated above, the usual trigger for a restructuring is the actual or imminent breach of a financial covenant ratio. These have the virtue of being relatively unambiguous[15] as either the borrower demonstrably and objectively has or hasn't met the relevant financial covenant as provided for in the credit agreement. Prior to the occurrence of a financial covenant breach, creditors may investigate their ability to rely on a material adverse change (MAC) provision either by reference to a standalone MAC event of default or by reference to some other representation or covenant which is nonetheless qualified in its application by reference to a MAC.

13.45 As a general statement, creditors are unlikely to receive sufficient legal succour from their counsel that would allow them to rely solely on a MAC as a restructuring trigger. This is because the drafting of MAC clauses always includes some element of subjectivity and therefore an inherent risk that relying on it as a sole event of default will lead to a damages claim for breach of contract and/or tortuous liability if it is subsequently established that a MAC had not in fact occurred. Whilst, in the context of English law governed loan agreements, the House of Lords judgment in *Concord Trust v Law Debenture Trust Corporation plc*[16] has given some comfort to

[15] The complexity of financial covenant definitions, particularly under leveraged loan documentation, can lead to disagreements about whether a particular covenant has been complied with or not. Following the downturn in financial markets after 2007, there have been several high-profile examples of disagreement between creditors and sponsors/debtors over financial covenant calculations, particularly in relation to the impact of gains under debt-buy back transactions and the impact this has on EBITDA, for example, Endemol and Mauser.

[16] [2005] UKHL 27. The House of Lords ruled, on the specific facts of this case, that the bond trustee could not be sued for damages (under contract or tort) for the losses suffered by an issuer as a result of wrongful acceleration (i.e. acceleration on the basis of an event of default that had not actually occurred). The reasoning given was that, absent an express term prohibiting the issue of an invalid notice of acceleration, such a term would not be implied into the agreement unless it was necessary to give business efficacy to the contract. The notice of acceleration was therefore simply ineffective. For a further discussion of this case and MAC clauses more generally see Suhrud Mehta, 'Material Adverse Change Clauses in Adverse Markets', 3 October 2008, available at <http://www.milbank.com/NR/rdonlyres/F6BDC4A0-B496-43D6-A1D2-74896FFB2563/0/Material_Adverse_Change_Clauses_Mehta.pdf>.

trustees, agents, and creditors that their liability for incorrectly calling an event of default may not be as great as previously feared, the reality is that it will remain only in the most clear cut cases that creditors will formally rely on a MAC-based event of default.[17] Creditors will, however, use the MAC informally to attempt to hasten the debtor into restructuring negotiations.

Creditor organization

13.46 Following or shortly before the occurrence of the relevant restructuring trigger, creditors will seek formally to organize themselves in preparation for any restructuring negotiations. Depending on the size of the lending syndicate, it will often be in the company's interests, as well as its creditors, to appoint a lead bank or banks as formal 'coordinators' of the restructuring as well as a coordinating or 'steering' committee of (usually) the largest creditors, who will act as the main channel of communication and 'sounding board' for the syndicate as a whole during the restructuring. The Loan Market Association (LMA) has produced standard form coordinator/coordinating committee appointment documentation[18] which covers (a) the relationship between the company and the coordinator(s)/the coordinating committee and (b) the relationship between the coordinator(s)/coordinating committee and the lending syndicate as a whole. It is important to note that the role of the coordinator(s)/coordinating committee is purely administrative; it does not have an advisory role and many of the provisions included in the LMA precedents are aimed at making this point clear, i.e. express acknowledgement that the coordinator(s) and coordinating committee members have no fiduciary duties or general duty of care to any person and are not responsible for the accuracy or adequacy of any information or advice received in connection with the restructuring.

13.47 Whilst the identity of the coordinator(s) and the composition of the coordinating committee will usually be dictated by creditor exposure, other factors can be relevant, such as previous restructuring experience, geographic presence, and industry expertise. In smaller restructurings, particularly where the outstanding debt is predominantly held by one or two large institutions, it may not be necessary to have a coordinating committee and the organization of the restructuring will simply be conducted via one or two coordinating banks. Substantively however there is no difference between a coordinator's role and that of a coordinating committee.

[17] See *BNP Paribas v Yukos Oil* [2005] EWHC 1321 for an example of where the lenders successfully established, following a challenge from the debtor, that a MAC had occurred.

[18] Available to Loan Market Association members at <http://www.loan-market-assoc.com>. Note that these documents (or documents based on these standard forms) are generally used for restructurings in the European bank loan market. Different approaches may be necessary where, for example, the project has been financed by institutional investors in the bond market.

13.48 Depending on the complexity of the project company's capital structure, it may be necessary to have more than one coordinating committee/coordinator. For example, in transactions which have been financed by a combination of bank and bond debt, there may well be a bank coordinator/coordinating committee and some form of ad hoc noteholder committee. Likewise, if the project has been financed with mezzanine debt, the mezzanine creditors will usually want to organize separately from the senior creditors and may therefore appoint their own coordinator/coordinating committee.

13.49 Each relevant committee/coordinator will appoint its own legal advisers and usually its own financial advisers. The company will be expected to reimburse the creditors for the costs of these advisers and the indemnity for this will be covered by the form of coordinating committee appointment letter referred to above and/or by the standstill agreement referred to below.

13.50 Once the coordinator/committee infrastructure is in place, it will be the coordinators, committees and their advisers which assume primary responsibility for:

(1) negotiating the standstill arrangements with the company (see in paragraphs 13.61–13.65 below);
(2) leading substantive restructuring negotiations with the company and amongst the various stakeholders to determine the form of restructuring; and
(3) negotiating the actual documentation by which the restructuring is implemented.

Information gathering

13.51 When a company experiences, or is exhibiting signs of, financial distress, the creditors' immediate priority will be to gather and analyse as much relevant information as possible. Establishing the infrastructure for the flow of information, including appropriate confidentiality agreements, will therefore be the number one priority in the early stages of a restructuring.

13.52 Prior to engaging in substantive restructuring negotiations, all stakeholders (although in particular financial creditors who will not be as close to the distressed entity in comparison to its sponsors and directors) will want as much information as possible to understand (a) the causes of the financial distress and the future prospects of the company, including its fundamental debt service capacity and (b) their rights under the relevant transaction documents and the rights of other stakeholders. It is on the basis of this information that a determination will be made as to whether the company has any realistic prospect of being successfully restructured on acceptable terms or alternatively whether it is beyond salvation. This phase of a restructuring has been described as:

> . . . a time when the size of the problem is ascertained, the lending, asset and group structure charts are being prepared, the strategy of the business is re-evaluated, recent

> trading is assessed, cashflow is analysed, a schedule of banking facilities is prepared, the recourse of creditors and the maturity of their credit lines are established, other non-bank creditors are contacted and intra-group positions are analysed.[19]

13.53 A restructuring will therefore often involve as much information gathering and diligence (if not more) than when the original financing was put in place. As noted in paragraph 13.42 above, however, given that project finance covenants require extensive ongoing reporting and information provision, project finance creditors tend to be relatively well informed as to the state of a project and its underlying finances in comparison to the creditors in normal corporate financings.

Financial information

13.54 The typical financial information which creditors will request in a distressed scenario consists of:

(1) rolling twelve-week cashflow forecasts delivered on a weekly basis, including a management commentary on any variances between actual cashflows and projections on a week-to-week basis;
(2) a revised business plan, included detailed financial projections; and
(3) a management explanation as to why the financial difficulties have occurred.

13.55 In order to assess the reliability of the financial information provided by a distressed company, creditors will almost always commission a firm of independent reporting accountants or financial advisers. Creditors will want independent verification that the financial information and projections provided by the company as part of the restructuring negotiations are not over-optimistic (management denial of a business's fundamental problems is not uncommon) or, of equal concern, such information and forecasts are not subject to management/sponsors 'low-balling'.

13.56 'Low-balling' (or 'sandbagging') is a reference to the fact that, once having accepted the reality that a restructuring is necessary, it is possible that sponsors and management may use that restructuring deliberately to understate the future prospects of the company in the hope that this may entice creditors to reduce the debt burden of the company more than they otherwise would be prepared to do. Another dynamic that can emerge in this respect is that management, whose performance incentives may be reset as a part of a restructuring, may have an in interest in deliberately underplaying the chances of the restructured entity's success so that their restructured management incentives are linked to more easily achievable targets. Whether to guard against over-optimism or the more cynical practice of 'low-balling', creditors will place significant reliance on the work of their own

[19] Chris Howard and Bob Hedger, *Restructuring Law and Practice* (Butterworths Lexis Nexis, London 2008) p. 17.

independent reporting accountants/financial advisers to give them a realistic view of the company's finances and future prospects.

13.57 Of particular relevance to a project financing, where the financial distress has been caused by a fundamentally incorrect assumption about the relevant market for the particular asset or otherwise as a result of a mismatch between the assumed economics of the project's offtake or other arrangements and the debt serviceability and profile of the originally financed debt, creditors will want to understand this and may commission new independent third party technical and/or market reports in order that the original assumptions can be re-set as part of the restructuring and a new financial model constructed on the basis of these revised assumptions.

Legal due diligence

13.58 Creditors will, as part of the information gathering process, seek legal advice on the scope of their security, the options for enforcing that security and the risks and limitations in pursuing such an enforcement. When embarking on a restructuring, whilst security enforcement will typically be considered a last recourse option for the reasons analysed in paragraphs 13.99–13.105 below, creditors will nonetheless want to establish at the outset their downside scenario in the event that consensual restructuring discussions fail (and a base case as to which consensual proposals can be measured against) and to establish the leverage their security will give them *vis-à-vis* the debtor and other stakeholders.

13.59 The legal due diligence for a project finance restructuring should also cover an examination of the change of control and other provisions in the key project contracts and/or project licences/concessions to determine what impact an actual enforcement will have on the project's underlying commercial contracts. This will include an assessment of any direct agreement arrangements which may have been put in place with the relevant project contract counterparties.

13.60 As explored in Chapter 11, direct agreements will include rights to transfer a project company's contracts to a creditor sponsored vehicle. These step-in rights are regarded as crucial in a project financing as they theoretically allow, when combined with the creditors' proprietary security rights, the ability of the creditors to take over the project, ensure that it is completed/operated, and therefore that the cashflow on which their repayment depends is generated and sustained. As explained in paragraphs 13.104–13.105 below, the contrast between the theoretical exercise of these rights as written in the various contracts and their operation in practice, means that direct agreements may be of limited utility in certain circumstances, particularly where the debtor enters some form of formal insolvency procedure.

The standstill agreement

13.61 Following the occurrence of, or immediately prior to, an event of default under its financing documentation, the distressed company will be anxious to secure a formal

recognition that financial creditors will 'standstill' for a period of time, i.e. agree not to exercise any of the rights they may have under the relevant finance documents as a result of the occurrence of that event of default. Standstill agreements take many different forms but generally cover the items summarized under in paragraphs 13.66–13.73 below.

13.62 The standstill agreement will be particularly important when the directors of the company are considering their potential liabilities under the law of the jurisdiction in which the company is incorporated (see paragraphs 13.14–13.20 above). A standstill agreement, whilst not a panacea, will often give directors significant comfort that they can continue to trade whilst restructuring negotiations take place. This will particularly be the case if the standstill agreement contains provisions relating to the formal deferment or waiver of interest payment obligations as this will mean that the directors will have some comfort that the company will not imminently become cash-flow insolvent (i.e. unable to pay debts as they fall due). In addition, the existence of a standstill agreement can be very helpful for the debtor to manage its day-to-day trading relationships with suppliers and customers; these third parties will take some comfort from the fact that financial creditors have agreed to standstill and hence that the debtor is not at imminent risk of a formal insolvency process. As a result, third parties may feel more comfortable in continuing to trade with the debtor company during the period in which restructuring negotiations take place.

13.63 In addition to the directors, a standstill agreement will give comfort to creditors as a whole (and other interested stakeholders) that a single creditor will not take precipitative action and, in this respect, an all creditor standstill arrangement helps to create a level playing field and a framework in which information can be shared and discussions held without fear that one creditor (or a group of creditors) will seek to use their contractual leverage to their advantage during the restructuring negotiations.

13.64 In a project finance context, where it may also be necessary to restructure certain of the project contracts, it may be necessary to bring any relevant counterparties to the project contracts into the standstill arrangements if, for example, there has been a payment default by the project company under an important supply contract.

13.65 If it is not possible to negotiate a standstill agreement during the initial stages of a restructuring, the company may have no option but to file for some form of formal insolvency process in the relevant jurisdiction and, if possible, negotiate a restructuring from behind the protection of any statutory moratorium or 'stay' that insolvency process provides.[20] There are, however, plenty of examples of

[20] Whether or not the directors are able to remain *in situ* following the filing for formal insolvency proceedings will depend on the type of proceedings available in each particular jurisdiction. In a number of jurisdictions, the filing for a formal insolvency proceeding will lead to an insolvency

restructuring situations where for various reasons, usually related to the complexity of the capital structure, it has not been possible to formalize a standstill arrangement amongst creditors but nonetheless, without the sanctity of either a statutory or contractual stay or moratorium, the company has continued to operate for months with a *de facto* standstill whilst restructuring negotiations take place.

Contents of a standstill agreement

Overview

13.66 The general objective of a standstill agreement is to provide the company with guaranteed financial stability for a period of time (the 'standstill period') by preventing creditors taking any form of enforcement action or otherwise exercising their rights under the relevant finance documents against the company during that period. During the standstill period stakeholders will analyse the relevant information, conduct restructuring negotiations and, in the event an agreement is reached, enter into a formal restructuring agreement (see paragaph 13.84 below) which will contain the framework for implementing the restructuring as well as reflecting the economic terms of that restructuring.

Contractual 'moratorium'—the standstill

13.67 The key operative provision of a standstill agreement will therefore be the creditors' formal agreement and undertaking not to take any form of enforcement action or otherwise pursue available remedies against the company (either as a matter of general law or in accordance with the particular rights provided for in the finance documentation). This contractual moratorium will be drafted very widely to cover any and all rights, including the right to accelerate the facilities and/or place them on demand, set-off rights, and any statutory insolvency remedies, for example, the right to petition for a winding-up in respect of an unpaid debt.

13.68 Where there are already standstill provisions included in an existing intercreditor agreement as between senior and junior tranches of debt[21], consideration will need to be given to the operation of these provisions and their interaction with the general standstill provided for in the all creditor standstill agreement. For example, the senior creditors will want to ensure that the standstill period negotiated with the company as part of the standstill agreement does not, in the event that restructuring

practitioner or other court-appointed or supervised trustee assuming control of the company in place of the directors. This approach contrasts with, for example, the 'debtor in possession' characteristic of Chapter 11 in the United States.

[21] In senior/mezzanine financings, the mezzanine creditors are typically required under the intercreditor agreement to standstill for a period of time following the occurrence of an event of default. The typical formulation is ninety days for a payment event of default, 120 days for a financial covenant event of default and 150 days for any other event of default. The mezzanine standstill is subject to certain exceptions, for example, the mezzanine creditors are able to take enforcement action if the relevant obligor is subject to an insolvency event.

negotiations fail, prejudice the separate standstill provisions between the senior creditors and the junior creditors in the relevant intercreditor agreement.

Interest deferral

13.69 Depending on the circumstances, as mentioned above, a standstill agreement can also include provisions whereby creditors will agree to defer or forego certain interest payments. This will obviously only be agreed to by creditors reluctantly and only where the alternative for the company is cashflow insolvency during the standstill period.

Continued access to facilities

13.70 Assuming that an event of default acts as a draw-stop to any existing facilities (see paragraph 13.96 below), the standstill agreement may set out provisions regulating the continued ability of the borrower to draw down on the facilities. These drawings may attract 'super priority' status. If new facilities are to be made available by the creditors to the company to enable it to meet its liquidity requirements during the standstill period then the arrangements for the priority of this new funding can also be reflected in the standstill agreement.

Company undertakings

13.71 Creditors will expect a quid pro quo for their forbearance and a standstill agreement will typically include new obligations on the company. Depending on the situation, these new obligations can include:

(1) granting new or additional security or improving or remedying any defects with the existing security;[22]
(2) new restrictions imposed on the company with respect to the use of any surplus cash (although, in a project finance context, the existing accounts agreement will already regulate all of the project's cashflows);
(3) an undertaking not to prefer one creditor (or group of creditors) over another by the repayment of individual debts or the grant of preferential security or other credit support;
(4) an undertaking to pay the fees of any advisers engaged by the creditors;

[22] In a project finance context, all relevant assets will usually already be secured. If any new security is given or amendments are made to the existing security, creditors should be aware that, depending on the jurisdiction, new or amended security may be subject to new hardening periods and/or otherwise be voidable in respect of the relevant jurisdiction's transactional avoidance provisions which apply in a subsequent insolvency. For example, in England new floating charge security which is granted for existing debts will generally be voidable if the company subsequently enters into liquidation or administration in the period of twelve months from the granting of that security and was unable to pay its debts at the time of giving the security or became so as a result of the transaction (s 245 of the Insolvency Act 1986).

(5) an agreement to cooperate with creditors and work towards a restructuring plan, including the provision to the creditors and their advisers of all necessary information;
(6) an obligation to provide certain deliverables by certain dates, for example, production and distribution of a new business plan and delivery of a comprehensive restructuring proposal and an undertaking to provide certain of the periodic information referred to in paragraph 13.54 above, for example, weekly twelve-week cashflow forecasts; and
(7) an obligation not to take action which may jeopardize the company's financial position.

The duration of the standstill period

13.72 The length of the standstill period will vary from case to case although typically creditors will not want the standstill period to be too long, with a view to 'keeping the debtor's feet to the fire'. It is usually the case that the initial standstill period will be extended a number of times during the course of the restructuring negotiations as circumstances dictate. In addition to a 'backstop' standstill expiration date, the standstill agreement will usually include a number of automatic termination events. These will include the occurrence of an insolvency event, the company failing to comply with the undertakings given by it in the standstill agreement, and the occurrence of any other event of default under the finance documents not otherwise specifically disclosed in the standstill agreement. In addition, the creditors (usually on a majority basis) may negotiate the right unilaterally to terminate the standstill agreement.

Reservation of rights

13.73 Even if the creditors have already issued a formal reservation of rights letter to the company on the occurrence of the first restructuring 'trigger', the standstill agreement will usually include a formal reservation of rights and will make clear that, immediately upon the expiration/termination of the standstill period, the rights the subject of the standstill will immediately become exercisable.

Restructuring negotiations

13.74 Whilst there may have been preliminary discussions about the actual substance of a restructuring during the time that the restructuring 'infrastructure' (appointment of advisers, coordinating committee documents, information gathering, standstill agreement, etc.) is being put in place, it is likely that the substantive restructuring negotiations will only begin in earnest once these processes have been finalized. Prior to engaging in substantive, all-stakeholder discussions, certain protagonists may have chosen to align themselves with other stakeholders. These groupings will vary from restructuring to restructuring; in recent leveraged restructurings a pattern has emerged of sponsors aligning themselves with the senior creditors in an

attempt to disenfranchise mezzanine or other junior creditors. As a result of these groupings, often competing restructuring proposals will develop and central to each proposal will be the protagonists' views as to the ongoing debt capacity of the company and, most importantly, the appropriate valuation of the company, as explored below.

Restructuring valuations

13.75 The determination of who is 'in the money' and who is 'out of the money' depending on what valuation is applied to the company and in what context lies at the very heart of restructuring negotiations. Inevitably, a number of the different protagonists will have different and strong opinions on value depending on their position in the capital structure. The early positioning in restructuring negotiations will turn around a debate as to who the 'fulcrum' creditors are as it is likely to be the fulcrum creditors who will take pole position in driving forward the shape of any restructuring. The fulcrum creditor is a reference to those in the capital structure where value is deemed to 'break'. Those creditors who are completely 'in the money', whilst obviously interested in the outcome of a restructuring, have the comfort that they should not suffer a loss whilst those creditors who are completely 'out of the money', so the argument goes, should have no influence in the restructuring as they have no economic value left to protect. It is therefore those creditors whose debt is not entirely covered in accordance with the prevailing valuation but who still have an economic interest in the company who often take the lead in a restructuring.

13.76 As valuation is often highly subjective and depends fundamentally on the assumptions used and valuation method adopted, the scope for argument and debate on this key issue is considerable. Whilst there are a number of complex nuances to the valuation debate in restructurings, the fundamental schism is between whether a liquidation/distressed sale valuation is the appropriate valuation technique for a financially distressed company or whether the valuation should be based on the going concern valuation of the entity assuming it has been successfully restructured.[23] As the range of valuations between a liquidation or 'fire-sale' approach (at the lower end) to a valuation based on the inherent, ongoing value of an entity post-restructuring (at the higher end) can be in the tens if not hundreds of millions (depending on the size of the company), the determination of the 'correct' approach can have a fundamental impact on determining the identity of the fulcrum creditors. The issue is further complicated by the complex, multi-tiered capital structures that have been adopted in the past decade as this further increases the scope for valuation arguments as between different tranches of debt.

[23] See Michael Crystal QC and Rizwaan Jameel Mokal, 'The Valuation of Distressed Companies—A Conceptual Framework', 2006 (available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=877155>) for a summary of a number of the valuation arguments in this respect.