The Project Finance Law Review

Editor
David F Asmus

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THE PROJECT FINANCE LAW REVIEW

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David F Asmus

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PREFACE

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

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

I would like to express my thanks to all of the authors of this inaugural edition. It is never easy to be a pioneer, which in this case entailed late nights drafting chapters from scratch for a new publication. Our authors have executed this task with distinction and aplomb. It is the hope of all of the authors that this volume not only will be of use to all of its readers today, but will also continue to grow in scope and utility in the years ahead.

David F Asmus
Sidley Austin LLP
Houston
April 2019

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Chapter 10

TYPICAL SECURITY ARRANGEMENTS FOR A SINGLE SOURCE PROJECT FINANCING

Borja Contreras and Ignacio Álvarez[1]

I INTRODUCTION

A comprehensive security package is a common feature of most (if not all) project finance transactions. Although the specific scope of the security package varies depending on certain circumstances (e.g., jurisdiction or type of project), lenders will usually require security interests over all or most of the project's assets and rights, as well as over the shares in the project company and other forms of equity, to feel comfortable with a non-recourse or limited recourse, highly leveraged financing, as project financings usually are.

The aim of this chapter is to cover the following matters regarding typical security arrangements for a single source project financing:

a the role and main purposes of the security interest package;

b the scope and typical security interests that usually comprise the security package; and

c a brief overview of the following matters concerning security interests: governing law, formalities and publicity, documentation, enforcement and foreclosure, and the negative pledge covenant.

Personal guarantees and other forms of support by or recourse to the sponsor, such as completion or cost-overrun guarantees are not covered in this chapter.

II ROLE AND MAIN PURPOSES OF SECURITY INTERESTS

i Foreclosure and use of the proceeds to repay the loan

Security interests are commonly regarded as a safeguard for the lenders to be repaid. That is, if the borrower is unable to serve the debt or is otherwise in default, the lenders may, by foreclosing on the security interests, sell the assets subject to security and use the proceeds to repay the financing.

However, while this is indeed a purpose of the security interests (and certainly an important one, at least hypothetically), it must be noted that, leaving aside jurisdiction-specific restrictions and limitations to foreclosure of security interests that apply generally or to the resulting sale and transfer of the pledged assets or rights,[2] foreclosure of security interests in project financings is rarely an expected or desired outcome for lenders, as the proceeds of the foreclosure are unlikely to suffice to repay the loan in a distressed situation, especially

1 Borgja Contreras and Ignacio Álvarez are senior associates at Uría Menéndez Abogados, SLP.

2 For example, the transfer of certain administrative concessions, authorisations, licences or permits may require prior administrative consent in some jurisdictions.

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during the construction phase or early stages of an operation. In this regard, the market for a project in the context of foreclosure proceedings (which in many cases will be the result of structural problems different to mismanagement, such as regulatory changes or problems with key project participants such as the constructor) will usually be quite shallow. It will, therefore, normally be difficult to have a fairly ascertainable value and to maximise the price in a foreclosure sale.

Furthermore, normally only a foreclosure that allows a third party to acquire, directly or indirectly, control over all the assets and project contracts required to complete the construction or operate the project (or both) will make economic sense for potential third-party bidders but standalone project assets or rights will rarely have much value.

ii Protection against other creditors

Even if the 'aggressive' use of security interests described in Section II(i) is of limited value to lenders, security interests provide them with other benefits that should not be disregarded. Most importantly, secured lenders will normally rank ahead of other creditors with respect to the assets taken as security both in a pre-insolvency scenario (attachments resulting from enforcements by unsecured creditors will usually rank junior to the lenders' lien) and in an insolvency scenario (in cases of a sale or liquidation in the course of insolvency proceedings, secured lenders will normally be repaid first with the proceeds of any asset charged in their favour).

iii Other advantages in cases of insolvency

Depending on the governing insolvency regulations, security interests may provide different advantages to the secured creditors, such as protection from the effects of composition agreements or other similar arrangements that can be crammed down on dissenting creditors, or limitations on the stay of foreclosure proceedings during the insolvency proceedings.

iv Preservation of the project assets

Security interests also serve the purpose of preserving the project's assets since they constitute a serious obstacle for the assets to be disposed of without the secured creditors' consent. The facility agreement or other finance documents will typically include covenants aimed at preventing any such disposal, but security interests provide an enhanced protection in this respect since, due to their *in rem* nature, they will normally remain attached to the asset even if the borrower disposes of it in favour of a third party. Consequently, no reasonable and diligent third party will acquire a pledged asset to which the lenders have recourse, unless the outstanding senior debt is discounted from the price or repaid at the time of the acquisition.

v Control over the project assets

Either by including covenants to that effect in the security documents or by operation of law, security interests grant certain control rights to the secured creditors to ensure, *inter alia*, that the validity and enforceability of the security interest is not impaired, to preserve the value of the asset taken as security and, ultimately, to have control over the assets (without taking ownership).

In this regard, in some English-law based jurisdictions, secured creditors holding a floating charge over all or substantially all of the project company's assets that qualify as such under the applicable law may appoint a receiver that can take over the collateral and thus

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manage the business and operate the project in the best interest of the secured creditors with a view to repaying the amounts owed to them or maximising their potential recovery in a future sale (or both).

In jurisdictions where such a possibility is not available, control can be sought by other means such as:

a vesting secured creditors who have taken security over the shares in the project company with the shareholders' voting and political rights in the event of enforcement; or

b issuing a golden share in the project company to the lenders that would entitle them to appoint directors in the event of a default.

Control over the project and the project company should nonetheless be closely assessed by lenders in view of the law governing the insolvency of the project company and the risk of shadow directorship thereunder. In cases of insolvency in some jurisdictions, lenders who are considered to have been managing the project company in practice even if they formally hold no directorship or right to appoint any directors or equivalent officers (that is, the lenders are considered to have acted as shadow directors) could have their claims subordinated or face liability in similar terms to the actual directors of the project company.

III DESCRIPTION OF THE SECURITY PACKAGE

i Scope

In line with typical market practice, the security package to be put in place in connection with the relevant project financing should ensure that it serves the roles and purposes set out in Section II to the maximum extent possible.

As mentioned above, project financing lenders usually require a security package that covers all the assets and rights of the project company (and therefore all potential sources of income for the project), or at least those that are necessary for the construction, start-up, commissioning and operation of the project. Security granted by the sponsor is usually limited to the shares in the project company and other forms of equity contributed to the company, such as shareholder loans.

However, the above principle is subject to different limitations, such as the ones described below.

Legal limitations on the type of security interests available

In some jurisdictions, it is not possible to take security over assets of a certain nature or type (e.g., administrative concessions) or over future assets. If security over future assets is not available, lenders may require promissory security to be granted over future assets, which is a covenant to grant security over any new asset or right such as the rights under new project contracts.

In particular, floating liens or charges that operate as a blanket lien over all the assets of a borrower (or, in the case of a floating charge, a charge that only crystallises as a fixed charge over specific assets upon the occurrence of certain trigger events such as the commencement of liquidation proceedings or the enforcement of the relevant security) are normally only available in English-law based jurisdictions.

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Furthermore, the secured debt or obligations may also be subject to limitations in certain jurisdictions. For instance, in some jurisdictions it is not possible to create security interests over assets to secure debt or obligations that do not exist at the time the security interests are created or that may fluctuate (e.g., revolving credit facilities).

Contractual limitations to the creation of security

Project contracts and agreements conferring rights to use plots of land may contain limitations on the creation of security interests, especially if the foreclosure of such security may result in the assignment of the relevant contract or agreement (as opposed to a pledge over pure credit rights that, if foreclosed, will only result in the relevant counterparty making any payments under the relevant contract directly to the lenders instead of to the project company). However, lenders will typically assess this risk in their legal due diligence and require that these contracts be amended appropriately or will deal with the matter during the negotiation of direct agreements with the counterparties under such project contracts.

Costs and taxes

In some jurisdictions, the creation and perfection of security interests may trigger significant costs such as notarial and registration fees and taxes such as stamp duty. In such cases, lenders may be willing to relinquish having security over certain assets (e.g., those that trigger stamp duty) if they are comfortable with the remaining security package. Instead, they may accept a promissory security over such assets so that these security interests are created upon the occurrence of certain trigger events tobe agreed among the parties (typically, an event of default or ratios falling below or above, as applicable, certain thresholds). However, to the extent that the subsequent creation of the actual security interest pursuant to the promissory security arrangement requires any type of collaboration by the borrower (even if it has undertaken to provide such collaboration), or if it otherwise requires a lengthy process, the effectiveness of promissory security is very limited by comparison to proper security. As explained, triggers are usually related to distressed or troublesome situations and it is unlikely that the borrower will be willing to grant additional security and may try to avoid doing so by all legal means such as through injunctions or filing for insolvency.

ii Typical security package in a project financing

For the purposes of describing the typical security package in a project financing, we have assumed a simple structure where the sponsor directly owns the shares in the project company, which in turn has no subsidiaries.

If the project company (i.e., the borrower) has subsidiaries (e.g., a structure where the borrower is a holding company that has operating subsidiaries to which it on-lends the proceeds of the project financing), lenders will normally require those subsidiaries not only to accede to the financing as guarantors if they are not borrowers, but also grant security over all (or almost all) their assets in the same terms as described in Section III.ii (Security over project assets). The borrower would be required to grant security over the shares in any such subsidiaries and all of its remaining assets (if any).

In the event that there are different intermediate holding companies between the sponsor and the project company, lenders may take security over the shares in such holding companies or not depending on the specific circumstances. However, if any such intermediate holding companies directly or indirectly own projects different to the one being financed, security will rarely be taken over the shares in such companies as it would defeat the purpose

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of a non or limited recourse financing. In some cases, intermediate holding companies may be included in the structure for the purposes of, *inter alia*, making the lenders comfortable with their security package. There are jurisdictions where the creation or – more typically – foreclosure on the pledge over the shares in the project company may be burdensome and troublesome, whether as a result of foreclosure regulations and limitations applying generally or because of the specific circumstances of the project (e.g., change of control over the project company resulting from the foreclosure requires the administration's prior consent) and therefore, lenders may try to circumvent such limitations by taking security over an intermediate holding company incorporated in a lender-friendly jurisdiction so that they can swiftly take control (indirectly) over the project or sell it to apply the proceeds to repay their debt (or both).

Security over the project assets

As explained above, lenders will typically require the project company to grant security over all of its assets and rights.

Blanket or floating liens or charges

As explained above, in some jurisdictions it is possible to have a floating or blanket lien or charge over all (or substantially all) the assets of the project company. While there are differences between the different figures available in different jurisdictions, ultimately these figures enable lenders to take some sort of security over all the assets owned by the project company from time to time (that is, not only the assets owned at the time of the creation of the security interest, but also any assets that the project may own in the future).

Security over real estate assets held by the project company

To the extent that the project company owns any real estate assets (e.g., the plots of land where the project is located), lenders may want to take a lien over them. While liens, such as mortgages, over real property are available in most jurisdictions, such security interests usually lead to significant costs (e.g. stamp duty) and therefore, as explained in Section III.i (Costs and taxes), lenders may be willing to relinquish such security depending on the remaining security package and the nature of the project. Furthermore, project companies usually have lease agreements or other types of right of use over the relevant plots of land rather than acquiring them to reduce costs and minimise the risk assumed should financing for the project not be closed.

Security over amounts standing to the credit of certain bank accounts

Lenders will take security over the credit rights arising from the bank accounts opened by the project company (see chapter 10 'Project Cash, Typical Account Structure and Project Cash Waterfalls') or otherwise over the funds deposited therein. As an exception, the project company will usually successfully request that the bank account where amounts that can be distributed to the sponsor or shareholders are deposited not be pledged in favour of the lenders.

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Security over intangible assets

Although projects that are financed under project financing structures are typically not IP-driven, if there are any intangible assets or rights that are necessary to operate the project or are otherwise relevant to it, such as any intellectual property rights or technology licences, lenders will want to take security over them.

Security over equipment, machinery, vehicles, spare parts and other moveable assets

To the extent that these have a significant value or are necessary for the construction or operation of the project, lenders may want to take security over movable assets. In some cases, such as spare parts, the project company will want to ensure that the security created does not restrict the use and eventual disposal of the relevant movable assets or otherwise impair its operations.

Security over concessions, permits, licences, authorisations, or other rights vis-à-vis the administration

This might be a key element of the security package structure in cases where the relevant project is based on a concession or on projects, such as energy projects based on feed-in tariffs, where the project is entitled to receive all or part of its income from the administration (or any regulator, the system, market operator or other similar entity) according to the applicable laws. On the other hand, lenders will not be so interested in taking security over minor standard permits such as works licences. Local law will typically play a key role in the taking of security over administrative concessions, permits, licences and authorisations, since it may not be possible to take such security at all or the foreclosure thereon may be seriously impaired because of having to request some sort of consent to transfer the permits.

Security over project contracts

Project contracts (or the credit rights arising thereunder), such as the construction and the operation and maintenance agreements, are key for the construction, start-up and operation of the project. In some cases, such as projects based on one or more offtake agreements, they may also be the main source of cash flows. Consequently, lenders will seek to take security over these agreements (or have a conditioned assignment thereof) or over the credit rights arising thereunder (e.g., in the case of construction agreements, payment of liquidated damages or penalties in the event of delays), or both. If the enforcement or foreclosure of such security can lead to an assignment of the relevant contract, lenders will have to ensure that it is possible to do so according to the relevant contract or ensure that its properly amended prior to entering into the project finance documents or as a condition precedent to the first utilisation. Counterparties to project contracts may, however, refuse to accept the assignment of their contract to the lenders or a third party in the context of foreclosure proceedings without their prior consent.

Security over insurance policies

Insurance policies (or the credit rights arising thereunder) may also be pledged in favour of the lenders. However, lenders may also feel comfortable if they are included as direct beneficiaries of such insurance policies.

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Security over the shares in the project company and shareholders' subordinated debt

Given that under a project financing structure lenders should have no or limited recourse to the sponsor, the security granted by the sponsor is typically limited to the shares in the project company, the shareholder loans granted to the project company and, if applicable, other forms of equity (in the broad sense) contributed to the project company (or the securities representing title over such equity or ownership over the project company).

Security over shares in the project company can be especially valuable for lenders where the relevant jurisdiction does not permit the lenders to attain a comprehensive security package. Similarly, it is also a useful tool in jurisdictions where a blanket or floating lien or charge over all the assets of the project company is not available and therefore it is not possible to, in an enforcement or foreclosure scenario, take control over or sell to a third party (indirectly) the project as a whole. On the other hand, acquiring the shares in a project company means taking on board all the liabilities, obligations and responsibilities of that project company, which the lenders or third-party acquirers may want to avoid.

In some jurisdictions, it may not be possible for foreign lenders to take security over the shares in a local company, particularly in the case of projects in the public domain or in strategically important industries. This restriction may be circumvented in these circumstances by making a local bank take the security over such shares on trust for the lenders.

Additionally to the foreclosure and sale of the shares in the project company, this type of security interest may allow the lenders (1) to exercise the voting and other similar rights attached to the relevant shares; (2) to gain additional control with respect to any share capital increases of the project company; and (3) to include additional restrictions to the payment of dividends or any other distributions that are not specifically permitted in the finance documents.

If the sponsor or shareholder owning the shares in the project company is not a guarantor under the project financing, lenders would typically want it to waive or forgive any receivables that may be generated in its favour as a result of a foreclosure. The rationale being that it would be paying a debt that it does not owe itself and thus it would normally be entitled to be reimbursed by the project company. If such receivables are not waived or forgiven, the value of the shares in the project company would suffer significantly as the company would be acquired with a debt that is owed to its former shareholder in the same amount as the price paid for the shares (or, if lower, the amount of the project finance debt that was repaid using the proceeds of the sale).

In the event that equity committed by the sponsor is contributed in the form of shareholders' loans, lenders will normally have to take security over it to ensure that all of the equity interests in the project are covered by the security package.

IV OTHER RELEVANT MATTERS RELATING TO SECURITY ARRANGEMENTS

i Governing law

While many jurisdictions provide a reasonable degree of freedom to choose the governing law to loan documentation, such flexibility is usually reduced when it comes to security interests (in particular, with respect to formalities for their valid creation, perfection and publicity). In line with the *lex loci rei sitae* doctrine, the consensus in most jurisdictions is that the

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creation and perfection of security interests is governed by the law of the jurisdiction where the collateral is located. This principle will not create much debate when it comes to real property, but it might be trickier in the case of movable property or intangible assets.

Consequently, ultimately it is quite common for the law of the jurisdiction where the project is located to govern the creation and perfection of security interests even if the loan documents are subject to a different law. It is therefore crucial for lenders to ensure (typically by engaging local counsel) that they have a clear understanding of applicable local law in respect of security interests and, in particular, the differences between the types of security interests available (e.g., fixed and floating charges and liens, mortgages, pledges or assignment by way of security); the limitations on the scope of the security package; the formalities required for the valid creation and perfection of security interests; and the limitations and restrictions applicable to enforcement, foreclosure and other remedies available.

ii Formalities and publicity

The applicable law may impose different formalities to the creation and perfection of security interests or to their subsequent enforcement, which can also result in higher costs and taxes.

Those formalities will vary from jurisdiction to jurisdiction but can include requirements as to the type of document in which the security interests are formalised,[3] the language of the documents,[4] the registration of the security interests in public or private registries,[5] or the transfer of the possession of the asset from the owner to the beneficiary of the security interest.

Security interests in most jurisdictions require some publicity to be valid and enforceable (especially in the event that the project company becomes insolvent), or to be effective against other creditors of the project company or other third parties (e.g., a purchaser of a collateral pledged in favour of the lenders).

The method to achieve publicity mainly depends on the nature of the collateral and the applicable jurisdiction, but there are two main forms: (1) transfer of possession of the collateral to the relevant secured creditor; or (2) registration with a public or private registry (which can actually be a way of achieving the transfer of possession as further described below).

How possession is transferred will depend on the nature of the collateral and may vary from an actual physical transfer of possession of the collateral to the secured creditors, to a more instrumental or fictitious type of transfer of possession, such as registering the security interest in a registry, serving notice of the creation of the security over a project contract to the counterparty thereunder, or simply executing a notarial deed in which the security is formalised.

3 For example, local law may require that security interests be documented in a deed or in a notarial document to be valid.

4 For example, documents may need to be drafted in or translated into the local language either for their registration or for enforcement purposes.

5 For example, local law may require mortgages over real property to be registered in a land or similar registry or security over shares in the project company to be recorded in the shareholders register.

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iii Security documents

Depending on the jurisdiction, all or most security interests can be granted in an omnibus security agreement, but it is also customary to execute a security principles document that identifies the main terms and conditions applicable to each of the local security documents that must be formalised in the relevant jurisdictions by reason of language or local formalities (e.g., notarisation).

Security documents can vary significantly, but the contents will usually include, *inter alia*:

a regulation of the creation and perfection of the security;
b regulation and mechanics of the extension of the security to other assets (e.g., in the case of security over shares, its extension to any newly issued shares);
c regulation of the release and cancellation of the security interests whether as a result of the fulfilment of the secured obligations or in other situations such as a permitted disposal of the collateral;
d representations and warranties including, most importantly, those relating to title and ownership over the collateral and its main features or characteristics;
e covenants normally relating to the maintenance, use and preservation of the collateral;
f remedies, enforcement and foreclosure of the security interests;
g miscellaneous provisions; and
h governing law and jurisdiction.

Security documents tend to be highly technical due to the applicable formalities and therefore few commercial or business issues arise when negotiating them. In any event, lenders (and their counsel) will typically seek to ensure that (1) the security interest is validly created and perfected; (2) the documents procure that the validity and enforceability of the security cannot be impaired; and (3) enforcement and foreclosure can be as swift and smooth as possible. On the other hand, the project company will try to ensure that the security documentation does not impose further restrictions and limitations to its operations than those heavily negotiated in the loan documents.

iv Enforcement and foreclosure

The remedies available for secured creditors vary significantly from one jurisdiction to another. For instance, remedies in many jurisdictions are limited to foreclosure and sale of the collateral (typically in some sort of auction), while in others the range may be wider including the direct appropriation of the collateral by the secured creditors or the appointment of a receiver as further discussed in Section II.v.

Furthermore, foreclosure mechanics and restrictions also vary significantly from one jurisdiction to another. To assess the quality of their security package, lenders should not only be concerned about its scope, but also about the mechanics of foreclosure under the applicable law.

In particular, lenders should consider the following matters carefully:

a the application of compulsory grace or cure periods prior to foreclosure and limitations as to the right to foreclose (e.g., courts in some jurisdictions may be reluctant to uphold a foreclosure based on a technical or minor event of default);
b the availability of different foreclosure routes (e.g., in and out of court) and mechanics (e.g., private bilateral sale versus public auction);
c the obligations relating to the maximisation of the value of the collateral in its realisation;

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d the impact that the insolvency of the project company may have on foreclosure (e.g., foreclosures may be stayed during all or part of the duration of insolvency proceedings);

e the limitations or restrictions on secured creditors participating in foreclosure auctions and credit bids (i.e., whether lenders can bid in their debt at foreclosure instead of doing so in cash);

f the expected costs arising from foreclosure; and

g the time frame applicable to foreclosure proceedings.

v Negative pledge

Project finance documentation will normally include, not only the obligation to grant in favour of the lenders the security interests discussed in this chapter, but also a negative pledge covenant preventing the project company from granting any type of security over its assets (subject to certain exceptions such as those arising by operation of law or certain baskets that may be negotiated among the parties on a case-by-case basis) to provide additional protection to secured lenders with respect to their ranking.

Although this mechanism provides the lenders with additional comfort that no other third party will inhibit their rights to repayment (especially in the cases where the facility agreement also provides for additional covenants that aim to secure the equal treatment of all the creditors such as *pari passu* and cross default), it is worth noting that this undertaking will not be binding upon third parties and will typically not prevent the generation of legal liens, encumbrances or charges by operation of law, or prejudice any legal privilege relating to priority of payments.

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Appendix 1

ABOUT THE AUTHORS

BORJA CONTRERAS

Uría Menéndez Abogados, SLP

Borja Contreras joined Uría Menéndez in 2011. He was appointed senior associate in 2018. Between September 2017 and June 2018, Borja worked in the New York office of Paul, Weiss, Rifkind, Wharton & Garrison LLP, where he was a visiting lawyer in the finance team.

He has over eight years experience advising lenders and borrowers on corporate, acquisition and project finance. He has also advised creditors and debtors on restructuring the debt of some of Spain's biggest companies.

Since 2011, he has also participated in several sales and acquisitions of non-strategic assets of financial institutions, such as non-performing loans and real estate assets.

IGNACIO ÁLVAREZ

Uría Menéndez Abogados, SLP

Ignacio Álvarez is a lawyer in the Madrid office of Uría Menéndez. Ignacio joined the firm in 2010. Between January and July 2016, he was seconded to the London office of the US firm Shearman & Sterling LLP, where he worked in the capital markets group as an international associate.

Ignacio's practice is focused on financing and debt restructuring transactions, M&A and energy law. He has been involved in transactions involving the sale of non-strategic assets of financial institutions, such as non-performing loans, real estate assets and asset management platforms.

Some of Ignacio's recent highlights include advising international investors on the acquisition of solar PV portfolios, and the disposal of, and investments in, gas distribution companies, as well as advising sponsors on the execution and restructuring of renewable energy project financings.

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