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Project Finance Documentation

Fit for Purpose?

Possibly motivated by the easier access to capital and credit markets which prevailed until the recent market disruption, many participants in the project finance market have begun to question the nature of market standard project finance documentation – in particular its bulk and length.

What has led to the current situation? Project finance documentation has always been premised on the elimination of risk to the greatest extent possible – or at least the identification of risk at the earliest possible opportunity. The classical project finance transaction is financed on the basis that the lenders only have recourse to the project in question and related assets (including project contracts) after completion. Pre-completion the lenders may have access to a credit-worthy parent sponsor in which case the pre-completion risk is mitigated. However, in a structure without a creditworthy sponsor the risk is enhanced since the lenders will be disbursing funds with no backstop guarantee in the event that the project does not reach completion in the manner originally expected.

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In what way does this concern over documentation manifest itself in a practical sense? There are several aspects as follows:

- Construction documentation - There is a perception that over the last five years or so construction related documentation has become lengthier and more complex, frequently due to the requirements of project finance providers. Of course sponsors themselves should be looking for construction documentation which adequately protects their (and their shareholders') interests. Accordingly, lenders and sponsors should have a community of interest here. Occasionally, sponsors will seek to manage issues in construction as and when they arise rather than through comprehensive documentation. This approach is unlikely to appeal to lenders.
- Other project documentation - Again the interests of sponsors and lenders in finalising a suite of robust project documentation should theoretically coincide. Approaches may diverge where a sponsor expects to rely on a "practical" day-to-day management approach. In most cases early agreement between sponsors and lenders as to what are the key project agreements and the key commercial issues should avoid much of the perceived overkill.
- Direct agreements - Project lenders require the ability to step into the position of the borrower/sponsor in the event of a default under a project contract which might otherwise entitle the project contractor in question to terminate or suspend that contract. The perceived problems which have arisen are twofold. First, the scope of the project contracts where direct agreements are required. This can be mitigated by early agreement on the major project contracts where the lenders have a legitimate need to step-in. Second, the scope of the agreements which the project contractors are asked to enter into with the project lenders. There is no doubt that the length of direct agreements has increased over the past five to ten years. On the other hand the equality of bargaining power in the context of project contracts has tended to slide in favour of those contractors during the same period. Again, up front agreement on important project contracts and undertakings required from project contractors could save time here.
- Security agreements - Project finance is premised on the basis that the lenders will be able to take control of and transfer all material project assets in the event of a problem with the project financing. This expectation must be balanced against the fact that in certain jurisdictions the granting of security may just not be possible (for example, the grant of security over minerals in the ground in Russia). Early stage planning and agreement on the scope of security can save much time and effort.

- Loan documentation - Possibly the greatest degree of criticism is directed at the project financing documentation itself. Loan agreements have extended to one hundred and fifty pages – and more – without schedules. We believe that this is for a number of reasons including the following:
  - loan documentation generally has expanded in length with the advent of standard market forms from the LMA and similar bodies. This is not restricted to project finance.
  - there is a tendency to start the documentation process with a previous form with the result that agreements expand through organic process. This seems to apply in particular to insurance, technical and operational issues.

While it will be interesting to see what effect, if any, current market conditions have on the approach to documentation, it is clear that there are issues here which are worthy of further consideration. The cost and time involved has begun to attract attention from all involved in the industry, particularly when compared with alternative products such as trade/commodity finance and capital market products (although of course none of these may be viable alternatives for any particular project for a variety of reasons).

Mayer Brown is very interested in pursuing these themes further with all industry participants and will shortly be arranging a seminar to discuss and hopefully advance some of the themes referred to above.

For more information about this topic, please contact:

Ian Coles
Partner
T +44 20 3130 3205
E icoles@mayerbrown.com