Legal Risks in Infrastructure and Project Finance Analytical Considerations

This document highlights relevant legal aspects for the credit analysis of infrastructure and project finance. These legal considerations play a key role in Scope's analysis because they are linked to analytical assumptions in the analysis of credit risk. Such assumptions would be adjusted to the extent that the legal considerations mandate.

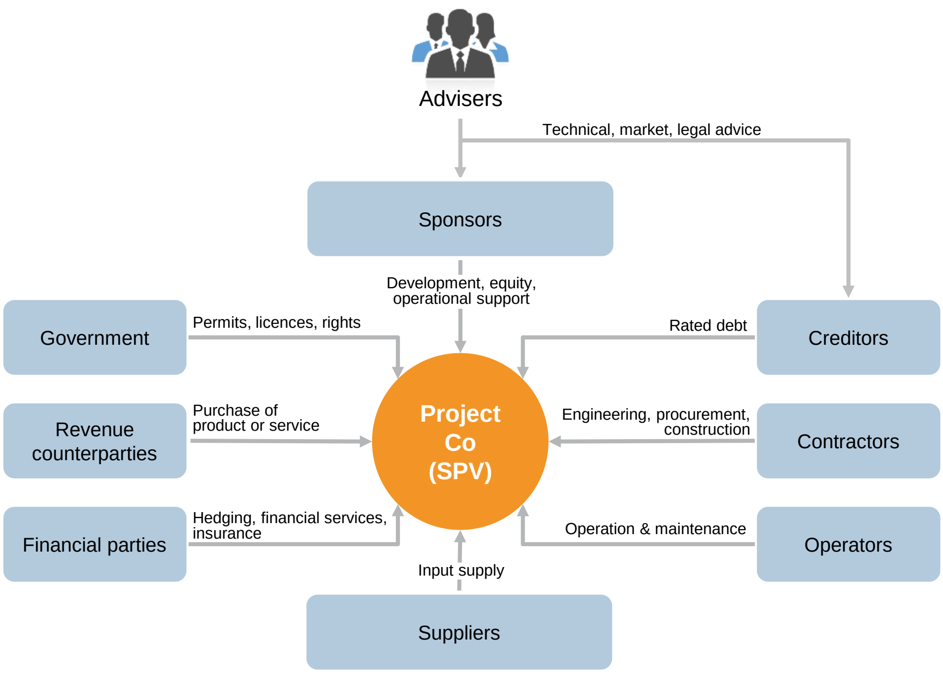
1 Introduction

Scope adjusts its analytical assumptions according to the legal principles described in this document. Most of these legal principles translate into the features shared between projects commonly identified as 'bankable projects'. The legal aspects also determine the mechanisms and features Scope can or cannot give credit to when analysing sources of credit enhancement in a transaction. However, these legal guidelines do not constitute a rigid or exhaustive set of requirements. Scope captures the credit implications in its analysis in transactions where certain legal elements are missing. Scope reviews legal opinions to gain comfort on its analytical assumptions in relation to relevant legal issues.

Scope considers the individual project, the contractual structure, the incentive mechanism and other aspects of each transaction when analysing the impact of legal aspects and their mitigants on credit risks. The credit view that emerges in the analysis of a transaction depends on the applicability of the legal principles described in this document, in addition to a project's fundamental characteristics.

Scope scores the contributions to total loss of the different risk factors in the context of its General Project Finance Rating Methodology. Scope's analysis generally considers three sources of possible legal risks: i) the contract structure; ii) the issuer of the rated debt; and iii) the transactional parties and documents as outlined in Figure 1. These legal considerations examine the three main sources of legal risk in further detail and discuss elements that could give rise to possible legal risks.

Figure 1: Sources of possible legal risk



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Most of the concepts described herein were developed over time by the project finance industry and have, to a large extent, resulted in legally robust structures commonly known as ‘bankable projects’. Scope understands that legal issues may be weighted in many different ways in a transaction and can be mitigated using alternative approaches.

This document provides an overview of the general legal issues that Scope typically examines when assessing project finance transactions. The legal concepts likely to influence ratings are common to most project finance transactions, regardless of the applicable jurisdiction. Scope assesses whether these principles are maintained by the jurisdictions applicable to the transactions.

Scope relies on internal legal expertise, transaction legal opinions and external legal advice, if necessary, in the course of this assessment.

2 Enforceable contracts

Project finance relies on the enforceability of contracts

The quality of the underlying project and its contracts, and the SPV’s legal recourse to the proceeds from them, are key elements of any project finance transaction. Scope assesses whether the payment obligations owed to the SPV are, legal, binding, valid and enforceable to ensure that the project produces the cash flows necessary to cover the SPV´s liabilities.

Legal opinions confirm claims’ validity and enforceability

Scope considers the validity and enforceability of obligations, typically confirmed by a legal opinion. The existence and enforceability of the claims and obligations stemming from the project contracts may be challenged by applicable laws. These laws may prohibit certain transactions (e.g. usury, fraudulent dealings, collusion); grant some counterparties extraordinary termination rights (termination for public interest); or stipulate formal prerequisites (e.g. filings, notarisation). In exceptional cases, existing law may even compromise certain concession agreements (e.g. when regional public entities enter competencies restricted to the central government).

Set-off and encumbrances can negatively impact on ratings

Any factual elements necessary for the obligations to be considered existing and enforceable would be explicitly represented by the sponsor or the financial advisers acting on its behalf. Scope may limit its assessment to considering whether one of the transaction parties (i.e. the sponsor or the security trustee) is contractually obliged and capable of checking the existence and enforceability of the contracts, especially where the assets of the SPV consists of a portfolio of several projects (e.g. in a holding company financing).

Set-off and encumbrances may have a negative impact on the ratings of some project finance transactions. Creditors may not always be able to fully benefit from payment obligations, even if they were originated in a valid and enforceable fashion. For example, any rights of the obligor to refuse full payment due to statutory defences or contractual changes to the payment obligations must be taken into consideration.

2.1 Set-off

Counterparty crossclaims could be set-off against SPV claims

Set-off rarely occurs in project finance because the existence of reciprocal claims, between the SPV and third parties, that can be set off is not common. Set-off can be of concern in projects that depend on payments from a single counterparty to generate revenues, such as concessions or power purchase agreements. Set-off may be invoked by a debtor where it holds a monetary crossclaim against the creditor. In this case, the debtor may be entitled to be absolved from honouring the creditor’s claim to the extent of the crossclaim. The set-off right may be a statutory defence or contractually agreed, depending on the jurisdiction. Set-off may be waived by contract if it is a statutory defence.

Set-off can be mitigated by contract or alternative means

Due to the above-described mechanism, set-off exercised by a debtor in relation to the asset may substantially reduce or completely cancel out the enforceable claim, i.e. the cash flows of the SPV. Scope examines whether the documents relating to the asset contain waivers of set-off and whether these are valid under the relevant jurisdiction where such crossclaims exist or are likely to come into existence. Scope assesses whether any features have been implemented in the structure to mitigate the negative impact of set-off in case such waivers have not been agreed upon or are not recognised by the applicable jurisdiction.

Set-off may also create challenges for the structure if invoked by transaction parties other than the project parties, for example the account bank. In this case, Scope examines how set-off is treated in the transaction documents mentioned below and how it affects the structure.

2.2 Encumbrances

Third-party security interests may impede creditors' claims

Other impediments to creditors' claims on the issuer's cash flows are encumbrances of the rights to it, i.e. if any of these rights have been pledged, charged or are subject to a security interest for the benefit of a third party. This third party may be entitled to enforce its rights to the asset if the preconditions to such enforcement have been fulfilled. Scope will assess if these public records have been checked by the transaction counsel where such encumbrances must be made public, for example recorded in a register as is the case for German mortgages. Scope may rely on appropriate representations if such publication requirements do not exist.

3 The issuer

An SPV helps isolating the project from sponsor risk

The issuing SPV constitutes one of the defining features of any project finance transaction. It serves as the mechanism de-linking the underlying project from the credit risk of the sponsor and hence enables the structure to rely solely on the cash flows generated by the project.

The issuer must fulfil several restrictive criteria in order to ensure that the payment deriving from the project is neither interrupted nor negatively affected in any way. These criteria can be grouped into the main goals to be achieved by the SPV: bankruptcy remoteness and non-consolidation. Bankruptcy remoteness should prevent the SPV from entering into insolvency proceedings. Non-consolidation should prevent the project of the SPV from being affected by the insolvency of its parent or other related company.

Bankruptcy-remoteness and non-consolidation

Bankruptcy remoteness and non-consolidation are targeted by using different types of corporate entities as SPVs, which will vary according to the jurisdiction under which they are set up. Some jurisdictions have issued specific laws providing for the incorporation of bankruptcy-and-consolidation-remote SPVs with the aim of facilitating project finance and other types of asset-backed finance transactions. A corporate entity not benefitting from this kind of statutory backup could nevertheless be set up in such a way that the necessary requirements are met. Project finance transactions occasionally rely on Orphan SPVs and/or on jurisdictions that provide appropriate legal frameworks to ensure bankruptcy remoteness and non-consolidation.

3.1 Bankruptcy remoteness

Bankruptcy remoteness reduces the risk of the SPV becoming insolvent

SPVs are set up as bankruptcy-remote vehicles so that the risk of insolvency proceedings being initiated against the SPV is reduced to the greatest possible extent. The importance of this feature must be considered in light of the effect an insolvency proceeding would have on the transaction. First, it affects the payment of interest and principal from the SPV to its investors. For example, payments may be disallowed in an insolvency scenario in order to protect other creditors. Second, a credit impairment event resulting from such a shortfall may give the investors the opportunity to enforce the security interest over the project granted to them. Enforcement action could then result in potential costly debt restructuring. Finally, insolvency will most likely trigger the termination of the contracts the SPV has entered and which are vital for the project's continued operation.

Contractual restrictions and debt limitations

The different structural elements resulting in bankruptcy remoteness can be separated into restrictions that have been contractually agreed by the transaction parties and those that limit the number of potential claimants against the SPV. These elements apply cumulatively to the structure.

3.1.1 Contractual restrictions

The essential contractual arrangements include limited recourse and non-petition clauses, which generally form part of any transaction document creating potential obligations for the SPV. Their purpose is to prevent the transaction parties from initiating bankruptcy proceedings against the SPV. The SPV typically grants pledges over all its assets to a trustee, for the benefit of the investor, thus reducing other creditors' incentive to file for bankruptcy. Legal opinions will usually confirm that these contractual arrangements are valid, legally binding and enforceable.

3.1.1.1 Limited recourse

Creditors subject their recourse to a payment waterfall

All creditors of the SPV (including the investor) agree to limit their recourse against the assets of the SPV. The limited recourse will typically be subject to the cash available under the waterfall of payments, complemented by a corresponding limitation of the termination rights so that if the cash flow does not cover the obligations towards the SPV´s creditors after application of the waterfall, it will not constitute an event of default.

3.1.1.2 Non-petition

Creditors agree to not initiate insolvency proceedings

All creditors of an SPV (including the investor) typically agree not to file, initiate or join in any insolvency proceedings against the SPV. Given the uncertainty in some jurisdictions as to the validity of such clauses, the non-petition clause is sometimes limited to a certain time period.

3.1.2 Asset pledges

Creditors defer enforcement to a security trustee

Pledging the SPV's assets to a security trustee for the benefit of the investor provides the latter with recourse to the assets should this prove necessary to protect its investment. More importantly, it is crucial in the context of bankruptcy remoteness to dissuade other creditors from filing for bankruptcy. Ultimately, the investors will have priority over the proceeds from the enforcement into the assets and no significant assets to be liquidated for the benefit of other creditors should remain in the estate of the insolvent SPV.

3.1.3 Debt limitations

The SPV is prevented from taking on additional debt

The SPV typically complies with certain conditions that ensure it does not incur obligations other than those subject to the provisions in the transaction documents. The purpose is to limit the risk of the SPV becoming insolvent due to a mismatch of incoming and outflowing cash flows; ensure that the waterfall is not affected by any debt that was not initially anticipated in the structure; and prevent third parties from filing for bankruptcy of the SPV. These conditions are commonly made subject to representations of the SPV which often include the following:

- No existing debt: the SPV has no legacy obligations towards third parties in case it has not been set up explicitly for the rated transaction.
- Limitation of debt: the SPV is prohibited from incurring any debt other than that created in the transaction documents and by applicable law, including taxes. If it envisages incurring further debt, this may be capped in order to be quantifiable for the purpose of the credit risk analysis.

- Limited business purpose and powers: the SPV´s constitutional documents provide for a business object and powers that are strictly limited to the project, the issuance of the debt, and the dealings necessary to set up the transaction structure.
- No employees: the SPV is prevented from entering into commitments in connection with employment contracts including pension liabilities except if specifically set out in the project agreement for the purpose of accomplishing the project.
- No subsidiaries: the SPV is prohibited from creating any subsidiaries that in turn could incur obligations for which the SPV might ultimately be liable.

3.2 Non-consolidation

The risk of commingling SPV assets with another entity

Scope views consolidation risk as the threat that the SPV and/or its assets could be consolidated with (the estate of) another legal entity. This consolidation could ensue from corporate reorganisations or insolvency proceedings relating to the parent company.

3.2.1 No corporate reorganization

Negative covenants often restrict the SPV from entering any mergers, acquisitions, consolidations or other forms of corporate reorganisations to prevent a corporate reorganisation from affecting the SPV or its assets. These negative covenants normally extend to ruling out dissolution, liquidation or sale of assets, although such negative covenants do not strictly address consolidation risk per se.

3.2.2 No statutory consolidation

In certain jurisdictions the insolvency proceedings may provide for the assets of the SPV to be consolidated with the insolvency estate of the parent company. This risk is sometimes addressed by using orphan SPVs or by choosing a jurisdiction that does not allow for such consolidations.

Structural elements can also mitigate consolidation risk if it is present in the applicable jurisdiction. The transaction typically includes elaborate separateness covenants and independent management provisions, etc. ensuring that the SPV will be treated by the applicable insolvency regime as a separate entity, which will hence not be consolidated with an insolvent parent company.

3.3 Other SPV safeguards

Other protections against third-party interference in the SPV

While Scope's legal analysis focuses on bankruptcy remoteness and non-consolidation, there are further contractual safeguards that are either indispensable or at least beneficial to the overall robustness of any project finance transaction. These include: representations regarding the fulfilment of appropriate regulatory requirements, the existence of an independent management, and a restriction on changes to the constitutional documents of the SPV.

3.3.1 Necessary licences and authorisations

Legal opinions typically confirm SPV representations on permits

The SPV must have all licences and authorisations necessary to ensure that it can conduct its business in full compliance with all legal obligations and regulations. Any lack thereof could endanger the validity of project contracts, void other transaction documents, or prompt fines from the supervisory authorities resulting in additional liabilities. Scope will analyse any related representations set out in the SPV documents together with the legal opinions, including potential qualifications in this regard.

3.3.2 Independent management

Independent directors enhance bankruptcy remoteness

The SPV is generally managed by a board that is independent from the SPV´s parent or other transaction parties. This prevents the board from being wrongly incentivised in its management of the SPV and also limits the risk of a dependent manager filing for voluntary insolvency to benefit certain transaction parties or the SPV´s parent company. One independent director may suffice depending on the capacities of individual board members according to the constitutional documents, and if that director is able to ensure that decisions taken by the board of the SPV are not influenced by any transaction parties having interests contrary to the investors.

3.3.3 No change to constitutional documents

Covenants prevent sponsors from retroactive changes

Scope is aware that the above-mentioned necessary restrictions applying to the SPV could be subject to changes by its owners, which are generally entitled by law to amend the constitutional documents at their discretion. Appropriate covenants prohibiting any changes without notification to the various transaction parties can mitigate this risk. This also includes related consents including, in certain cases, the approval of the investors.

4 Transaction documents

Any project finance transaction involves several transaction parties that are necessary for the performance of the structure. Scope would usually investigate the general documentary issues pertaining to all transaction documents and those that are relevant only to specific agreements depending on the role of the respective transaction party.

4.1 Analytical steps

Analytical steps to assess the transaction documents

Scope's legal assessment of the transaction document will generally follow certain analytical steps:

- Assessment of whether the project contracts and financing documents contain all services or other actions necessary for the performance of the project structure.
- Verification of whether anything in these contracts negatively affects the required cash flow.
- Check that the agreements with the transaction parties create valid, legally binding and enforceable obligations of the transaction parties vis-à-vis the SPV. Scope typically seeks legal confirmation and requests that the legal opinion covers all the transaction documents, i.e. all contractual arrangements entered into in relation to the rated transaction.

4.2 Transaction parties

Certain additional legal aspects are specific to the agreements with certain transaction parties, for example the investors and providers of credit enhancement.

4.2.1 Investors

Terms and conditions of the debt instrument

The transaction document between the issuing SPV and the investor usually consist of a subscription agreement including the actual rated debt instrument (e.g. note). The terms and conditions of a market standard note or syndicated loan facility typically contain the following provisions:

- Use of proceeds
- Standard representations, warranties and covenants (as partly discussed above)
- Status of the debt instrument
- Cash-flow priority of payments
- Financial covenants and testing dates
- Various potential forms of credit enhancement e.g. cash sweeps and distribution lock-up mechanisms
- Account definitions and allocations of moneys
- Limitation of termination rights for the SPV
- Interest payment date (possibly subject to deferrals)

- Final legal maturity (not subject to deferral)
- Decision by the noteholders, reserved to holders of rated notes with an appropriate quorum

4.2.2 Providers of credit enhancement

External credit enhancements such as guarantees and sureties

Credit enhancement can stem either from third parties or from structural elements contained in the transaction documents. Scope will consider whether the agreements with the providers of credit enhancement or the structural elements are covered by a legal opinion when assessing their credit impact.

4.2.3 Third-party enhancement / guarantees

Third-party credit and structural enhancement take various forms: guarantees, letters of credit, swap contracts, liquidity facilities, etc. This document focusses on guarantees as they constitute a key form of third-party credit enhancement. Guarantors provide credit enhancement to the structure by way of credit substitution. Scope will consider whether the credit risk of the guaranteed transaction party can be replaced by the credit risk of the guarantor.

Guarantees may allow for credit substitution

Credit substitution may be contemplated if the guarantee features the following characteristics:

- **Irrevocable**: the guarantee cannot be revoked in relation to obligations entered into prior to the termination of the guarantee.
- **Unconditional**: the claim of the guarantee is not conditional upon the beneficiary of the guarantee having pursued its rights vis-à-vis the debtor or the completion of other prerequisites.
- **Waiver of defences**: the guarantor forgoes the defences that the principal debtor may have against the fulfilment of the guaranteed obligation.
- **Pari passu**: the guarantee ranks at least pari passu with the other senior unsecured obligations of the guarantor.
- **Beneficiaries**: the guarantee is for the benefit of the SPV, the security trustee or the noteholders and enforceable by the same.
- **Amendment/termination**: any amendment or termination of the guarantee is typically subject to the consent of the beneficiary. The guarantee will generally provide for an obligation to notify the rating agencies of any amendments. The notification obligation will encompass any change of guarantor (e.g. by way of merger, corporate restructurings, etc.).

4.2.4 Structural elements

Common structural credit enhancements

Structural credit enhancement elements are common in project finance transactions and include the following:

- **Subordination**: the claims of a junior investor are subordinated to those of a senior investor as the junior investor is paid only after satisfaction of the senior investor´s claim; thus, subordinated investors absorb the first losses.
- **Overcollateralisation**: the fundamental economic value of the project exceeds the obligations under the issued debt instruments.
- **Distribution lock-ups**: distributions to sponsors or debt service to junior investors can only made if certain minimum debt service coverage and leverage thresholds are met.
- **Cash sweeps**: excess cash flows must (partially) be applied to early repayments. The amounts of early repayment may be based on certain conditions such as credit performance, time, or target repayment amounts.

- **Reserve funds**: the SPV retains cash as a reserve to cover costs, first losses, or to provide liquidity support. The reserve fund, if drawn, is typically replenished by extra cash available after the application of the cash-flow waterfall.

5 Taxation

Tax liabilities are critical due to their super-senior status

Scope considers any liabilities originating from taxes that could affect the cash flows and hence the rating promise. Potential tax liabilities are of major concern because they are senior obligations by law in most jurisdictions and a failure to pay could trigger regulatory actions affecting the SPV and the transaction structure. The fact that tax liabilities usually rank senior to all of the SPV's other payment obligations in the cash flow priority of payments highlight their significance.

5.1 Sources of tax liabilities

Taxes apply on multiple levels in the transaction structure

Tax liabilities arise for various reasons and take different forms. Scope groups these taxes according to the item they are related to:

- Project: taxes may be levied in relation to the project as withholding taxes on the payments to be made from the project to the SPV; as VAT on the acquisition of equipment; or as stamp duties for the perfection of security.
- SPV: taxes may also be charged in relation to the SPV itself, i.e. the earnings of the SPV could be taxable unless the SPV is tax neutral or tax transparent. If neither is the case, taxation would not affect the structure if only the profit is subject to taxation, i.e. the earnings after deducting the cash needed to service the rated debt plus senior ranking obligations.
- Transaction parties' payments: payments of third parties, such as providers of credit enhancement, could be subject to taxation as well.

5.2 Tax analysis

Tax opinions give comfort on key assumptions and jurisdictional specifics

Scope usually requests tax opinions to assess a transaction's tax liabilities.

Tax re-characterisation could create additional complexity, in particular in the case of cross-border transactions. Tax re-characterisation is relevant in transactions where a certain jurisdiction, other than that in which the SPV resides, applies its tax regime to the SPV. This could, for instance, be the jurisdiction in which a company providing all essential services to the SPV is domiciled. Secondary tax liabilities are relevant where the jurisdiction of an SPV's parent would claim unpaid tax liabilities of the parent from its affiliate, i.e. the SPV. Possible mitigants such as double taxation treaties governing potential cross-border taxation help to reduce taxes, but not their complexity.

Transaction contracts can mitigate tax risks

Scope may not need to rely on external tax assessments to demonstrate that no tax obligations exist as long the relevant transaction documents contain valid, legally binding and enforceable gross-up clauses in favour of the SPV; or if the generated cash flow suffices to settle all tax claims.

Scope's ratings do not address the potential taxes borne by an investor on his investment in the rated instrument.

6 Legal opinions

Scope relies on legal opinions of the transaction documents

Scope usually relies on external legal opinions in its legal review.

The legal opinions typically confirm:

- that all transaction documents constitute legal, valid, binding and enforceable obligations of the parties; and
- the effectiveness of SPV bankruptcy remoteness elements;
- the taxation of the underlying assets, transaction documents and the SPV.

Assumptions and qualifications are key considerations

The legal opinions may contain only the limited assumptions and qualifications that are standard for this kind of transactions. Scope will discuss any implications with the transaction counsel and the sponsor of the transaction if assumptions or qualifications cast doubt on the legal opinion. This allows Scope to adequately assess the issues raised and better understand their implications for the robustness of the structure.

7 Final remarks

Scope requests readers of these considerations on legal risks in project finance transactions to keep the following points in mind:

7.1 Change of law

This document reflects the legal situation as of its publication

These legal considerations reflect the legal situation at the time of their publication. This document will only be updated if these changes have a material impact on the legal considerations laid down herein. Changes in the applicable law are an ongoing process and one of the challenges to a legal analysis of project finance transactions. In addition, their interpretation (e.g. in jurisprudence or administrative guidance) significantly affects the robustness of the legal elements of project finance transactions leading to constant adjustments to the market standard documentation.

7.2 Miscellaneous

This document does not constitute advice

This compendium does not constitute legal advice, nor does it represent a promise by Scope that a certain rating will be achieved if all legal aspects described herein are covered by any structure presented for a rating.

Although Scope forms its own view on the legal robustness of project finance transactions, it acknowledges that the structures and legal elements of these transactions are driven by market participants and their legal counsels. Scope invites these parties, in particular, to contribute to the development of these legal considerations by sharing their views with Scope.

Finally, these legal considerations complement and should be read in conjunction with Scope´s General Project Finance Methodology.

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