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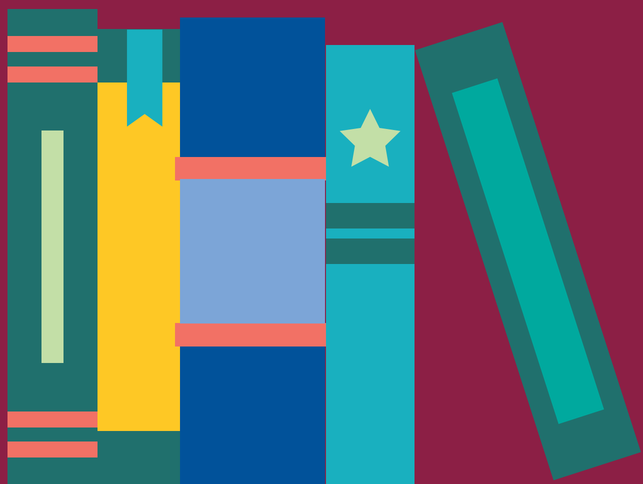

Chapter 12.
Explanatory memorandum to the model direct agreement template

1. Background

1.1 This explanatory memorandum ("memorandum") is intended to provide an overview of the key provisions of the model form non-concession Direct Agreement (Model DA) prepared by us, elaborate on its significance and purpose in the context of a project finance transaction, as well as possible negotiation issues, benefits and risks for the parties to a direct agreement (DA or Direct Agreement).

1.2 The Model DA and this memorandum have been produced under a premise that a non-concession DA is a Direct Agreement under a project where the Public Authority assumes the demand risk to the extent that the Project's profile is such that the source of all or most revenues received by the Project Company is the public side.

1.3 Save as otherwise provided herein, capitalised terms used in this memorandum shall have the meanings ascribed to them in the Model DA.

2. Direct agreement: overview

What is a DA?

2.1 A DA is a mechanism commonly used in project finance transactions which provides additional assurances to financial institutions financing an infrastructure project as to their ability to intervene in a project in case of a threat of a default. In particular, the Lenders would typically be entitled to temporarily take over the running of the project on the Project Company's side (step-in), novate the Project Agreement and related contracts to a new Project Company selected by the financiers, instruct payments to be made to their accounts or to an account over which the Lenders hold security interest, agree on a rectification plan with the government and otherwise keep the project going.

2.2 The rationale behind the use of DAs is that, in large-scale project finance transactions, Lenders are usually critically dependent on future cash flows of the Project for repayment of their loan. In the case of an ailing Project, Lenders will have limited recourse against the Project Company, its controlling entities (sponsors) and their respective estate and in many cases will not be able to levy execution on the public infrastructure constituting the subject matter of the Project Agreement. A DA therefore offers a practical alternative, putting the Lenders in a position to keep the Project alive by means of a suite of contractual rights to forestall a termination of the Project Agreement. Even though step-in rights under DAs are rarely formally used or enforced in practice, their existence facilitates a negotiation when a Project runs into trouble.

Parties to a DA

2.3 In a project finance transaction, the Project Company, the representative of the financiers (Agent) and the Public authority typically enter into a DA. Where the financing structure of the Project warrants the difference between the lists of Secured Parties and Lenders, the Secured Parties will nominate a Security Agent under the Security Documents. The Security Agent will need to be a party to the DA as well. If the Agent is a bank and acts as a Security Agent, wording must be added into the DA that the former acts for itself also. If there is only one lending institution in the project, the figure of an Agent may be superfluous and can be replaced with this Lender.

Nature and aim of a DA

2.4 Although not a security document in a legal sense as it does not create security interests, the DA is typically perceived as a quasi-security document giving Lenders a contractual alternative to a security, which the Lenders would usually seek in the case of a conventional "corporate" loan and which in a project finance transaction is either unavailable or limited in value. The DA is closely connected to the relevant Project Agreement between the Project Company and the Public Authority and to the Facilities Agreement(s) between the Project Company and the Lenders.

2.5 The primary aim of a DA is to regulate the relationships of the above three parties in case of termination or threatened termination of the Project Agreement and/or the financing agreements through the Project Company's fault with a view to allow the Project to survive and to protect the interests of the financing organisations.

2.6 As the termination of the Project Agreement is likely to lead to the suspension of the Project's operation or the collapse of the Project altogether, the DA will typically contain mechanisms enabling the Lenders to rectify the existing deficiencies while maintaining the operation and hence the cashflow of the Project, such as the obligation of the Public Authority to give notice before exercising its right to terminate the Project Agreement and Lenders' step-in right.

2.7 In this context, DAs are viewed as being beneficial not just for the Lenders but for the Public Authority as well, because they allow for keeping the project functioning in an otherwise imminent Project Agreement termination scenario. A good starting point for the direct agreement may be the United Kingdom's Standardisation of PF2 Contracts (SoPC) model. It is well known, universally accepted by the lending community and has been followed in many countries around Europe (most recently we saw that the equivalent document in Norway and Singapore drew heavily on the UK model, and we have previously seen it in many other countries across the world). In the United Kingdom, the SoPC model has been used for projects across all sectors, most of which have been accommodation-based projects such as hospitals, schools, prisons and government buildings.

DA: market practice

2.8 Typically, DAs follow a fairly standard approach which has been honed by the market practice. In many countries across Europe, non-concession DAs are frequently based on the recommendations and the model form contained in the Standardisation of PF2 Contracts guide published in 2012 by the UK HM Treasury (although no longer used in the United Kingdom since 2018, save for antecedent projects), subject to variations concerning aspects of the applicable law and commercial specifics of the particular project. The Model DA has been designed with reference to the market practice to reflect bespoke terms which have been tested across a variety of sectors and jurisdictions.

2.9 Non-concession DAs will not usually manifest a striking difference with concession direct agreements. That said, one may expect more emphasis on the terms of termination compensation in concession direct agreements because Lenders will want enhanced security over the single source of income, being the termination compensation. The Lenders' position on the release of security at termination of the Project Agreement may be less flexible in concession direct agreements because at the time of inking of a DA they would perceive themselves to be exposed to a higher degree of risk of not being repaid.

2.10 The signing of a DA will typically be one of the Public Authority's key obligations and a condition precedent to a Project's financial close. In some instances, debt may be extended to the Project Company before a DA is signed, but this will likely take the shape of a corporate rather than project finance borrowing, subordinated to that of the senior Lenders.

3. Key provisions of a direct agreement

3.1 Below, we have listed some of the key provisions of a DA. These will be explained in the next sections below.

3.1.1 Subject matter and key undertakings (optional)

A general section titled Undertakings which sets out the key undertakings of the parties to the DA. This section is a remnant of a conventional procurement, usually found in civil law countries.

3.1.2 Security

This section would include acknowledgement of the Security by the Public Authority and may also contain provisions regarding enforcement of the Security.

3.1.3 Public authority notice and lender notice

- The procedure for the termination of the Project Agreement by the Public Authority, including its obligation of the Public Authority to give notice to the Lenders of a (i) Project Company default and/or (ii) the Public Authority's intention to terminate the Project Agreement.

- An obligation of the Lenders to give notice before taking any adverse action, such as accelerating the debt and enforcing the security, may also be included.

- Obligation of the Public Authority to divert all payments due to the Project Company to a Lender's account after the receipt of a Lender's notice to that effect.

- Obligation of the Public Authority not to terminate a DA before the expiry of the Notice Period, the Rectification Period or the Lenders' decision not to step in or step out.

3.1.4 Lenders' step-in

A section of a DA which sets out the conditions and procedure for a Lender's step-in, the scope of control the Lenders' nominee acquires over a project and the process to step out.

3.1.5 Novation and transfer of control

A section of a DA designed to effect permanent transfer over a project to the Lenders' nominee or, in some instances, an entity selected on tender. This section also establishes the modus to replace the Project Company, being either through share transfer or novation of the Project Agreement (transfer of rights and obligations). A statement is also made in this part to the effect that antecedent violations committed by the Project Company shall not be counted against the

Lenders' nominee for the purposes of termination of the Project Agreement.

3.1.6 Other provisions

Other sections of a DA may cover tax gross-up in relation to any payments made to the Lenders under the Lenders Direct Agreement, as well as representations and warranties, waiver of sovereign immunity, no set-off, governing law, arbitration clause and the usual "legal boilerplate".

3.2 In certain challenging jurisdictions with limited experience of international financings, Lenders are known to require additional rebalancing of the project risk profile, including around the following:

3.2.1 right to call termination of the Project Agreement upon occurrence of an event of default under finance documents;

3.2.2 right to demand repayment of "gross" senior debt, that is, senior debt deposited on reserve accounts which has not been used to finance the Project;

3.2.3 additional representations and warranties on the part of the Project Company and Public Authority, such as, for the Public Authority, having sufficient budget funds and having made the necessary budget allocations to make payments under the Project Agreement;

3.2.4 language confining the Public Authority's rights under contractor direct agreements in order to ensure additional control over contract within the Project perimeter;

3.2.5 provisions going beyond those set out in the Project Agreement, for example, on the termination compensation, in instances where Lenders were unable to push through the required language into the Project Agreement;

3.2.6 an obligation of the Public Authority to pay the termination compensation in the currency in which the relevant amounts are expressed (that is, protection against the foreign-exchange risk), including, for example, the amounts of senior debt, import contracts or employment agreements;

3.2.7 indemnities to cover Lenders in certain circumstances, such as against invalidity of the Project Agreement or certain types of breach of contract by the Public Authority.

4. Consent to security and security enforcement

4.1 It is essential that a Direct Agreement has a provision whereby the Public Authority acknowledges, and consents to, the Lenders' security interests over the Project Company's rights under the Project Agreement (and the other Project Documents, such as the energy performance certificate and operations and maintenance agreements and a land lease) and other assets under the Security Documents. If the Project Agreement requires the consent of the Public Authority to a Security enforcement, it is important that such consent is granted in advance in the DA. There may also be certain legal doubts about the ability of Lenders to enforce security against assets and rights which relate to the public infrastructure and public services typically involved in a public-private partnership (PPP), which such consent can help remove. Such consent would serve as a protection measure enabling the Lenders to exercise their rights under the Security Documents confidently if needed.

4.1.1 The Public Authority should also confirm in the DA that it has not received notice of any other security interest granted over any of the Project Company's rights or assets under the Project Agreement and other project contracts.

4.1.2 The DA may also set out provisions with regard to the enforcement of the Security, which will be subject to the terms of the relevant Security Documents and may include, in particular, (i) ensuring that the relevant share and/or asset transfer is made to a person satisfying the definition of a Suitable Substitute Contractor; and (ii) the consequences of the enforcement of such Security (such as the exercise of the step-in rights under the DA being triggered).

5. Public authority notice and lender notice

5.1 One of the cornerstone provisions of a DA is the undertaking by the Public Authority not to exercise its rights of termination or suspension under the Project Agreement without giving the Lenders a prior written notice. The standstill period which starts after the Public Authority Notice allows the Lenders to exercise (or direct the exercise of) the Project Company's rights in an attempt to cure the existing default.

5.2 The length of the standstill period is potentially a negotiation point as the Public Authority will typically not be eager to grant longer periods of time given that the Project Agreement usually already contains a cure period for the Project Company to rectify a default.

5.3 The DA may also include an obligation of the Lenders to notify the Public Authority in writing of the occurrence of a Project Company Default or other Loan Default under the financing documents (the "Lender Notice"). This is primarily about transparency and the flow of important information which could impact the Project. These undertakings are more commonplace in DAs entered into in relation to projects where termination payments often cover not only 100 per cent of "gross" senior debt but may also include equity. In these scenarios, contracting authorities may feel the need for a greater level of control over the Project Company performance.

6. Step-in

6.1 Step-in is a contractual mechanism allowing the Lenders (or another person designated for this purpose to act on their behalf, since Lenders may not want or even be technically able to do so themselves), for a limited period of time, to perform the Project Company's rights under the Project Agreement. Normally, step-in is a temporary contractual arrangement, allowing a third party to exercise the rights and perform the obligations of the Project Company under the Project Agreement on its behalf, while the Project Company remains formally in place and liable for any breaches or losses it has caused under the Project Agreement.

6.2 A step-in is procured in favour of an Appointed Representative. An Appointed Representative can usually be nominated and take up the role on the issue of a Lender's notice to that effect and without needing a consent from a Public Authority as the necessary consent will have been given under the terms of the DA. No special requirements are usually imposed with respect to the standing or nature of an Appointed Representative.

6.3 During the step-in period

6.3.1 the Public Authority as a rule will be required not to terminate the Project Agreement unless Lenders decide not to step in or the Project Company commits a repeated breach. It is advisable that breaches which are an inevitable consequence of an original default(s) are excluded and so not lead to termination during the step-in period;

6.3.2 the Lenders are incentivised to ensure that a remedial programme is implemented in relation to antecedent breaches and that no new breaches occur. If antecedent breaches are not remedied then a right to termination can arise again.

Novation

6.4 The Direct Agreement also provides that the effects of the step-in can come to an end if the Lenders step out or a Novation occurs. If the Project Agreement continues by way of a Novation, this does not mean the parties will not amend the Project Agreement in certain respects. For example, the parties may agree that the performance and payment mechanisms are not incentivising the parties correctly and so require it to be amended.

6.5 A Novation is procured in favour of a Suitable Substitute Contractor. In contrast to an Appointed Representative, a Suitable Substitute Contractor must be a person or entity approved by the Contracting Authority and meeting a set of criteria specified in the DA, including appropriate qualifications and experience, as it will be permanently replacing the Project Company under the terms of the Project Agreement (and other project contracts) and must have the right capabilities to act in that capacity for the rest of its (and their) term. Those criteria are likely to have to be compatible with the criteria that were used in the selection of the original Project Company. But others may also be specified, such as a prohibition against using US- and/or EU-sanctioned entities. The Public Authority cannot withhold its consent to the appointment of a Suitable Substitute Contractor meeting the grounds and procedure for its appointment laid out in the Direct Agreement.

6.6 It is noteworthy that in some civil law countries as a matter of applicable law a contractual step-in mechanism may not operate in the same way as in common law jurisdictions. In these countries, especially with nascent PPP legislation or limited pipeline of projects, the question whether step-in can afford robust legal protection to Lenders and, when applied, not lead to invalidity of the relevant provisions of the Direct Agreement is moot. Oftentimes Lenders prefer to set aside step-in in favour of novation (or transfer of rights and obligations) which may or may not include "step-out", that is, provisions facilitating transitioning of the Project back to the original sponsors. One essential difference between step-in and novation is that in the former, the Project Company's obligations under the Project Agreement rest with the Project Company, which insulates the Lenders' nominee from Project-related liability and consequently improves the chances of finding a suitable substitute. In our view, there is no harm with laying the legal foundation of both step-in and novation in a Direct Agreement. This will provide extended flexibility to Lenders and ultimately benefit the Project as the Lenders will have more legal mechanics in place to rescue an ailing Project.

6.7 Where the Project Agreement is terminated following a period of an attempted rectification, including with the help of step-in or novation, the Project Company may be entitled to a termination payment. In developing economies, we have seen instances of such termination payments including both senior debt and equity, with the latter part payable to unsecured sponsor-controlled accounts. This is grounded on the premise that as a result of novation, the Project company sponsors will be stripped of a right to receive a termination compensation. To ring-fence their investments, they sometimes push hard to include provisions enabling them to be repaid regardless of the novation.

7. Rectification period and performance points

7.1 One key point is the extent to which any penalties for underperformance by the Private Partner can continue to accrue when the Lenders have stepped in. These may take the form of Performance Points linked to a government revenue stream where an availability payment structure is used (on a "non-concession" PPP) or specific penalties or liabilities on a user-pay structure (that is, a concession, unless the project is a purely "self-policing" one, where revenues from third parties fall as a result of poor performance).

7.2 To the extent the Performance Points accrual rate reflects the detriment to the Public Authority, then by Performance Points being incurred, the Public Authority is protected. Its main concern in such circumstances is to ensure that it is not paying for the Service if it is not being provided, or (more commonly) overpaying for a sub-standard service.

7.3 To the extent this is the case, then it may be advisable to postpone a termination for an extended period to allow rectification to occur. Sufficient flexibility should be included in the step-in period so default is not easily triggered (for example, if one more Performance Point during the step-in period can trigger a termination, the Lenders will be reluctant to step in) and time is given to rectify.

7.4 Performance Points should continue to accrue during the step-in period but during such period any previously accrued Performance Points will not count towards the termination threshold. The rationale is that the Public Authority should not be able to terminate the Project Agreement if the Lenders are using reasonable endeavours to rectify any breach that arose prior to the step-in date but which is continuing. If the Lenders subsequently step out, such suspension of the Performance Points should be lifted. If the Public Authority does not have this protection and the Lenders step out because they no longer wish to rescue the Project, the Public Authority will need to count those Performance Points that accrued prior to the step-in date towards the termination threshold. If the step-in period ends because of a transfer of the Project Agreement to a Suitable Substitute Contractor, any accrued Performance Points will be cancelled for the purposes of triggering a termination (but still payable in accordance with the Project Agreement or the Rectification Plan).

7.5 To the extent that a rectification programme is being implemented (and so termination right is suspended) a refinancing may be required to incorporate, for example, new working capital.

8. Other provisions

8.1 Unrestricted assets

8.1.1 On termination of the Project Agreement, the Lenders are normally asked to agree to release any security over the unrestricted assets (that is, the assets which are necessary for the delivery of the project after termination of the Project Agreement and are typically transferred to the Public Authority or its nominee), other than charges over bank accounts, and third-party claims (including claims against the Public Authority under the Project Agreement and the Sub-Contractors under the Sub-Contracts) as well as share pledges, rights under other assigned contracts, charges over assets of the Project Company which do not need to be transferred and so on. This is because a Public Authority will want to ensure that the operational assets which the Public Authority needs to complete or operate the Project pass across from the Project Company to the Public Authority on a termination so as to ensure continuity of service, and the Lenders' security arrangements should not prevent that. In practice, Lenders are often unwilling to release security over Project property before being granted documentary evidence to the effect that the Termination sum is or will imminently be discharged to them in due course (for instance, a cashier's order or an irrevocable payment instruction for the transfer). When the Project Agreement is terminated as a result of a Project Company default and where the Lenders do not have the protection (directly or indirectly) of a clear undertaking from the Public Authority that the totality of their outstanding senior debt will be paid, Lenders may ask instead to be allowed to seek the highest cash sum that can be achieved in the open market for the Project in default. It is then in the interests of the Lenders that the Project remains operational and can be sold in the market for its maximum value. As mentioned in paragraph 2 above, their real security is in the cash flow (or termination sum) rather than in assets. When termination occurs, leading to the public side's obligation to pay off the senior debt, Lenders are typically looking to retain security until the making of such payment.

8.2 No liquid market

8.2.1 The Project Agreement will usually set out the mechanism for calculation and payment of the compensation upon termination of the Project Agreement. The open market value of the Project may be one of the components of the calculation. If this is the case, the Direct Agreement should contain a "no Liquid Market" provision, which allows the Lenders to issue a written notice to the Public Authority that in their opinion no Liquid Market exists.

8.2.2 If the parties agree that no Liquid Market exists, there shall be deemed to be no Liquid Market for the purpose of the Project Agreement and the parties will need to determine the estimated market value of the Project Agreement, including on the basis of pre-agreed mechanics which factor in the termination scenario to arrive to the quantum of compensation payment. One way to do that is for the parties to agree in the Project Agreement a list of components of the termination compensation payable depending on the ground for termination.

8.2.3 If there is no agreement between the parties as to whether or not a Liquid Market exists, either party may refer the dispute to be determined in accordance with the dispute resolution procedure.

8.3 Representations and warranties

8.3.1 As a relatively recent development, a section on representations and warranties began to appear in Direct Agreements. Lenders often used this approach in high-risk jurisdictions to ring-fence against many commercial and legal risks by including extended representations and warranties on the Public Authority's end. Nonetheless, in our view, standard representations and warranties (such as addressing the right of the parties to enter into the Direct Agreement, due execution, the DA being binding and enforceable, any authorisations being in place), can still be considered as a matter of good contractual practice.

8.4 No set-off

8.4.1 As a matter of bankability requirement, DAs must include language preventing set-off of amounts payable to Lenders. This includes both senior debt and any liability under the Direct Agreement (for example, for breaching a warranty). However, if the agreement provides for any payments in consideration of junior or mezzanine debt (as is the case in some direct agreements concluded in the Commonwealth of Independent States), these, as a rule, would not be protected against set-off or other deductions.

8.5 Arbitration and governing law

8.5.1 Lenders expect that the Direct Agreement reflects bankable arbitration clauses. These would normally be rather boilerplate and concise with some commercial tension regarding the arbitration institution. However, as long as this is selected from a ratchet of the top reputable centres (ICC, SIAC, LCIA, ICC, CIETAC and HKIAC), there should not be an unresolvable disagreement between the parties on the matter. Note, however, that Public Authorities may oppose international arbitration and may insist on disputes being resolved in state courts, which would usually not sit well with Lenders as a matter of bankability.

8.5.2 In countries with limited PPP experience Lenders frequently request that English law govern the Direct Agreement. However, in practice where local law is prescriptive on the matter of the governing law pertaining to the Direct Agreement or where Lenders can be convinced to get comfortable with the law of the country of the Project origin (including by virtue of a positive legal opinion from a reputable legal adviser), or where Lenders are largely (or exclusively) local entities they often consent to the applicable national law. The Public Authority may also not be allowed to enter into agreements governed by foreign law – even when there is no direct prohibition, in many countries public authorities will resist a foreign law governed DA. Where possible, it is advisable that the governing law and arbitration clauses of a Direct Agreement are aligned with those of the underlying Project Agreement.

8.6 Other

8.6.1 As a matter of bankability, the provisions of a DA should prevail over the provisions of the Project Agreement and any other agreements entered into in connection with the Project.

8.6.2 Most capitalised terms in a DA would usually be defined through reference to the relevant definitions given in the Project Agreement and Facilities Agreement.