The Project Finance Law Review

Third Edition

Editor
David F Asmus

The Law Reviews

THE PROJECT FINANCE LAW REVIEW

THIRD EDITION

Editor
David F Asmus

THE LAWREVIEWS

PUBLISHER
Clare Bolton

HEAD OF BUSINESS DEVELOPMENT
Nick Barette

TEAM LEADERS
Jack Bagnall, Joel Woods

BUSINESS DEVELOPMENT MANAGERS
Katie Hodgetts, Rebecca Mogridge

BUSINESS DEVELOPMENT EXECUTIVE
Olivia Budd

RESEARCH LEAD
Kieran Hansen

EDITORIAL COORDINATOR
Gavin Jordan

PRODUCTION AND OPERATIONS DIRECTOR
Adam Myers

PRODUCTION EDITOR
Martin Roach

SUBEDITOR
Sarah Andreoli

CHIEF EXECUTIVE OFFICER
Nick Brailey

Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34–35 Farringdon Street, London, EC4A 4HL, UK

www.TheLawReviews.co.uk

ISBN 978-1-83862-816-1

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ABNR COUNSELLORS AT LAW

ALLENS

ASHURST LLP

BECCAR VARELA

CLIFFORD CHANCE

DLA PIPER UK LLP

FRESHFIELDS BRUCKHAUS DERINGER RECHTSANWÄLTE STEUERBERATER PARTG MBB

KING & WOOD MALLESONS

KIRKLAND & ELLIS LLP

L&L PARTNERS

MILBANK LLP

MORGAN, LEWIS & BOCKIUS LLP

SIDLEY AUSTIN LLP

SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP AND AFFILIATES

CONTENTS

PREFACE

I am pleased to introduce the third edition of *The Project Finance Law Review*, which now includes additional new chapters covering government investment agreements, commercial lenders, government funding and construction risk. This edition builds on the work from the first two editions, expanding both the scope and depth of the resource offered.

Recent years have seen many changes affecting the projects market, including enormous growth in capital directed toward renewable energy (and more novel projects such as carbon capture and storage, and hydrogen), the increasing impact of the regulatory environment on the viability of large projects and now, as the world gradually recovers from a covid-19-induced downturn, an abundance of government financing for selected projects as a part of various economic stimulus programmes. Project finance, unsurprisingly, 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.

This volume seeks to cover the most salient topics while leaving scope for expansion into other key areas (such as mezzanine financing, the effect of new technology risk on project financing and environmental, social and governance (ESG) issues) in future editions. 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, pension funds and sovereign wealth funds), changes in the nature of projects seeking finance (which now may involve new technologies such as carbon capture and even direct air capture of carbon dioxide) and more substantial environmental restrictions (particularly with respect to climate change concerns) in effect at key lending institutions all combining to change the complexion of the project finance market. The next several years should bring increased clarity to all of these subjects, including particularly the future of project finance in the oil and gas industry.

I would like to express my thanks to all of the authors of this third edition, and particularly those who have contributed new chapters or who undertook significant updates to their earlier work. Their efforts have allowed this volume to be more useful than ever as we enter a new decade facing increasing uncertainty in global politics and global markets, including the project finance market. 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 also will continue to grow in scope and utility in the years ahead.

David F Asmus
Sidley Austin LLP
Houston
April 2021

Part IV

Collateral and Guarantees

Chapter 11

TYPICAL SECURITY ARRANGEMENTS FOR A SINGLE-SOURCE PROJECT FINANCING: A SPANISH PERSPECTIVE

Joaquín Sales[1]

I INTRODUCTION

The security package in a typical project finance transaction does not focus on the actual value of hard assets, if any, at the beginning of the project, but on the gradual and progressive build up of value and control over project cash flows upon completion of its various stages of development. As a result, intangible assets will play a key role when shaping the security package.

Frequently at the early stages of the project, there are virtually no hard assets owned by the SPV acting as borrower. And those which may be owned by the SPV, most notably land rights, may not be suitable as collateral, or such security may trigger disproportionate tax costs, as we will explain below. Sponsors, on their side, will vigorously resist the granting of security over their own assets, not only on grounds of the potential foreclosure risk but on an actual impairment of their financial ratios, which could trigger an event of default under their facilities that is not related to the project in question. As a matter of fact, what we have seen in the past few years is an increased reluctance by sponsors to provide even personal guarantees to cover construction risk, which used to be standard in the past. In such a manner, the SPV's credit rights (receivables) arising from the project contracts/sub-contracts[2] will typically represent the most valuable assets for the purposes of providing collateral at the early stage of the project.

II GENERAL CONSIDERATIONS

i Uncapped liability beyond the security package

Before examining the security arrangements typically found in Spanish project financings, it should be emphasised that generally, debtors in Spain are subject to an uncapped liability regime for their obligations.[3] Accordingly, the incorporation of SPVs to develop projects and raise debt is the tool most commonly used to shield the sponsor's assets from any potential liabilities arising out of these projects.

1 Joaquín Sales is a partner at King & Wood Mallesons.

2 In infrastructure projects in particular, there tends to be an agreement with the procuring authority, typically in the form of an administrative concession, and then a set of sub-agreements for construction, operation and maintenance, etc.

3 Article 1911 of the Spanish Civil Code establishes the 'universal' liability of the debtor, being liable for the performance of its obligations with all its present and future assets. Consequently, the debtor shall respond

ii Recording in public deeds and public registries

Under Spanish law – being the governing law pursuant to the rule *locus regit actum* – most security interests are recorded in a public deed or commercial policy duly authorised by public notaries. These notarial documents ('public documents' in Spanish legal jargon) confer several advantages to security interests that go way further than access to public registries and enforceability effect. In particular, public documents provide certainty on the date of the security interest, which in case of insolvency of the debtor and conflict between different creditors, may determine which is the prevailing creditor.[4] Additionally, the perfection and enforceability of some security interests (e.g., mortgages and chattel mortgages) are subject to registration with a public registry, and this in turn requires them to be formalised in a public document (in these cases, it will be the date of registration that will determine the preference between conflicting creditors over the same assets).[5]

iii 'Global' versus 'specific' security

Global or floating charges over all the assets of the debtor are not admitted under Spanish law, and specific and independent security interests over specific assets must be created, depending on the nature of the asset.

As a matter of fact, a narrow interpretation of the principle of 'speciality' found in the Mortgage Law required that each security interest was granted to secure one secured obligation only (for instance, several rights of pledge could be granted over, say, the shares of the SPV: one in favour of senior lenders, another one in favour of the hedge provider, another in favour of guarantee facility lenders; these pledges in turn could all have the same or different ranks). This very conservative approach has been progressively abandoned, and it is now customary to grant security interests that cover several obligations (in our example, one single pledge of shares would guarantee the obligations under the senior facility agreement, the hedging documents and the guarantee facility agreement; an intercreditor agreement would then regulate how that security is enforced and enforcement proceeds allocated to the various creditors).

iv Common versus regional law

It should also be pointed out that several Autonomous Communities and territories in Spain (most notably Catalonia, the Basque Country, Navarra and Galicia) have their own private law legislation, which will prevail over Spanish common law applicable in all of the state. In particular, the Civil Code of Catalonia includes detailed regulations of *in rem* rights, including security interests (both over land and credit rights, including in connection with bank accounts opened in Catalonia).

of any outstanding debts not only with its current assets but with any assets owned in the future. While Article 140 of the Spanish Mortgage Act allows the parties to limit the debtor's liability to the specific asset subject to the mortgage, this provision is rarely used in the field of project finance.

4 The perfection of some security interests is determined by the date of filling the security deed in the relevant public registry such as the Land Registry, which does not always take place simultaneously with the granting of the public deed.

5 Non-possessory pledges are also registered but in this case the preference will not be determined by the date of its incorporation in the relevant registry.

III STANDARD SECURITY PACKAGE

This chapter intends to provide the reader with an overall approach to the typical security package present in project finance, and the main features of the same. The enforcement process of guarantees and direct agreements remain out of the scope of this piece.

i Hard assets

Security interests created over hard assets are articulated through various kinds of mortgages and pledges, depending on the specific nature of the asset at hand and its registrability in public registries.

Real estate

Real estate, including plots of land and constructions on the same, can be subject to a real estate mortgage, which must be granted in a notarial document and registered with the Land Registry. The security will not be effective until effectively registered (although, once registered, the date of effectiveness will be the date on which the document was filed with the Registry).

Real estate mortgages are seldom used in Spanish project finance (or almost any type of corporate financing, outside of real estate financing, for that matter) because of the very high cost associated with the same. The creation of a real estate mortgage will trigger stamp duties on the amount secured with the mortgage (which would typically include 100 per cent of the senior debt principal amount, plus between 25 per cent to 50 per cent more to cover interest, default interest and enforcement costs). The tax rate varies from region to region, ranging from 0.5 per cent to 1.5 per cent.

This does not mean that real estate is completely excluded from the security package. First, any real estate assets of the borrower will be covered by the negative pledge undertaking; while this is not a security interest as such, and certainly would not be enforceable against a third party that did acquire actual security in good faith, it is at least a valid obligation of the borrower, which could allow lenders to stop drawdowns, block the payment of distributions and ultimately accelerate the debt. Secondly, 'promissory mortgages' are often part of the security packages, consisting of an undertaking by the borrower to grant a proper real estate mortgage, pay the stamp duty and register it with the Land Registry, if certain trigger events occur, typically, the occurrence of any default, or the debt service cover ratio falling below a certain threshold (still above the default threshold). In addition, an irrevocable power of attorney is granted in favour of the agent or security agent, so that it can, on behalf of the borrower, grant any documents and carry out any actions required to perfect the security, until registration with the Land Registry. Again, a promissory mortgage, even coupled with an irrevocable power of attorney, is not in itself a proper security interest and will not prevail over a good-faith third party creditor, but it is considered to be a reasonable balance between the interests of the creditors and the borrower, in the face of the exorbitant tax costs (lenders taking the view that it is not an expense which will bring much value to the project, and that they will be reasonably protected with the rest of the security package).

Movable assets

Chattels or movable assets (e.g., solar panels and wind turbines) that can be properly identified, through serial numbers or otherwise, and that can be registered with the Movable Asset Registry, can be subject to security in the form of a chattel mortgage/non-possessory pledge (depending on the type of asset). These security interests are also created through a notarial document that must be registered with the Movable Asset Registry. As in the case of real estate mortgages, they will generally trigger stamp duties, so they are likewise avoided, and replaced by promissory security.

ii Project contracts and other receivables

As described in the previous Section, project finance in Spain is not heavily reliant on security over hard assets, be they real estate or movable assets. Security over credit rights/receivables is the backbone of the security package, including receivables under or in connection with:

a project contracts, for example, EPC/Construction agreement, O&M agreements and offtake agreements;

b insurance;

c bank accounts; and

d sponsor debt.

Project contracts

The rules applicable to creating security over project contracts are actually applicable to most other security over receivables, since these receivables will typically stem from contracts entered into by the borrower (e.g., insurance contracts, bank account contracts).

Security over receivables will typically be created in the form of a possessory pledge. This type of security interest does not need to be registered with a public registry, but the date on which it is created must be certain. As mentioned before, this is typically achieved by granting the security in a notarial document.

The first thing to be borne in mind is that the provisions in the underlying agreement between the project SPV and its counterparties, regarding the assignment of the SPV's rights, will determine if and how the relevant receivables can be subject to security. The general rule under Spanish law is that receivables can be freely transferred or assigned without the counterparty's consent, unless otherwise agreed. But if it is agreed in the contract that the receivables cannot be transferred or assigned without the counterparty's consent, or without meeting some other requirement (notice to the counterparty, for instance), these provisions will prevail and will need to be fulfilled in order to validly pledge the receivables. This is an issue that sponsors should be aware of, from the early stages of development of the project, to make sure that all project agreements are fully bankable.

Regarding notice to the debtors of the pledged receivables, it is not a requirement under Spanish law for the validity or effectiveness of the pledge. It will be necessary in order to enforce the pledge (issuing an instruction to the debtor to pay the secured creditors directly); however, and for that reason, it is customary in project finance transactions to deliver the notice upon execution of the pledge.

Traditionally, both in the energy and infrastructure sectors, projects were developed around an EPC agreement, which greatly simplified the creation of security, as there was only one contractor. In the past few years, however, multi-contract structures have become more common. This requires the SPV to pledge the receivables separately under each of those agreements, including any interface or coordination agreements, and to notify the relevant contractors separately.

Another matter worth pointing out is that Spanish pledge agreements do not typically include step-in rights, which are rather found in direct agreements. Only in cases where there is no direct agreement between the financiers and the project contractors, limited step-in rights are included in the pledge agreement, in the form of irrevocable instructions to the contractor, which it is required to accept.

Insurance

Insurance indemnities are pledged as described in the previous Section, as pledges of receivables (the insurance policy being the pledged contract). It is also customary that financiers require the security agent to be appointed as beneficiary of the relevant insurances, in addition to the rights of pledge over the project company's credit rights.

Provisions in the pledge agreement must be drafted carefully to be consistent with those in the finance documents regarding use of insurance proceeds, so that the rules set out for allocation of these proceeds amongst the various lender groups (e.g., senior lenders, VAT lenders, hedge providers) are complied with.

Third-party liability insurance policies, where a third party is the beneficiary of the indemnity payable by the insurance company, are typically excluded from the security package.

Bank accounts

All project accounts will be pledged in favour of the financiers, except perhaps for a distributions account, which can only be funded at the end of the payment waterfall, after financial covenants have been tested (at a level higher than the default threshold), and other standard requirements fulfilled; it is generally considered that funds in such a distributions account belong to the sponsors, rather than to the project.

Under Spanish law, creating a pledge over a bank account (which is technically a pledge of the receivables arising from the account agreement) does not per se block the account. The pledgor can generally continue to operate the pledged account, unless otherwise agreed. In the context of project finance transactions, the general rule is that the accounts will not be blocked as a result of the creation of security over the same,[6] but if certain trigger events occur (an event of default, a potential event of default, a deterioration in financial covenants), the security agent is entitled to deliver a blocking notice to the account bank, after which all account movements must be approved by the financiers (through the security agent). It should be noted that, if the accounts are not blocked, or the creditors are otherwise able to exert some form of 'control' over the same, according to the criteria laid out by the Court of Justice of the European Union, the pledge may not qualify as 'financial collateral', which could make it a more robust form of security, especially in the event of insolvency, and give creditors access to a swifter enforcement procedure; this is not generally viewed as a problem in the Spanish market.

In cases where the account bank is not one of the lenders, it is important that the notice of the pledge includes an irrevocable instruction of the pledgor to block the accounts if so required by the security agent, as described above, and to deliver to the security agent the balance of the accounts in the event of enforcement. These instructions should be accepted by the account bank, as they are critical for the lenders' control of the project's cash flows. The project accounts will typically be held by the senior lenders' agent, which will agree

6 Other than accounts which are set up for specific purposes, and can be considered to be 'blocked' by their nature, such as the debt service reserve account, a prepayments account, or a maintenance reserve account; in these cases it is common to find that they cannot be operated without the security agent's consent.

to operate the accounts in a manner consistent with the finance documents and comply with any blocking or enforcement instructions. However, we have seen cases where the project accounts have had to be moved to a bank outside the senior syndicate,[7] and these commitments have had to be negotiated with the new account bank.

Sponsor debt

All sponsor debt instruments will typically be pledged to the financiers. In some cases it is required that the sponsors forego all claims under these instruments against the project company, in the event of enforcement of the pledge over the project company's shares (as part of the total equity contributions), on the grounds that it will facilitate the enforcement of the share pledge. There is not really a market standard on this point, as sponsors generally resist waiving these rights.

iii Project company shares

Security over the shares of the project company takes the form of a pledge, granted in a notarial document. The pledge must then be registered with the company's shareholder ledger; in the case of public limited liability companies the share certificates are endorsed 'as security' and delivered to the security agent for their custody.[8] An annotation recording the pledge is also made in the notarial documents by virtue of which the pledgor acquired the ownership of the shares.

The use of 'blank' share certificates, which the security agent can fill in to transfer ownership of the shares upon enforcement of the pledge, and which is quite common in other jurisdictions, is not permitted under Spanish law.

Generally, creditors will pursue controlling the company in the event of default by exercising the political rights of the quota shares (e.g., voting rights), which requires an express provision in the by-laws in this regard. Creditors will, therefore, generally require that the by-laws stipulate that the exercise of all voting and economic rights attached to the shares correspond to the pledgee as from the moment on which an event of default has been declared, even before the pledge is formally enforced. Even though creditors generally require to be granted this right, in practice they tend to be quite reluctant to exercise it and have the voting rights vested on them, in order to avoid being considered as *de facto* administrators in an insolvency scenario.

In the event of enforcement of the pledge of shares, creditors will demand that the shareholders waive any rights of reimbursement against the project company, since this would prejudice the ability to sell the shares in an auction.

iv Permits

As a general rule, no specific security can be granted over administrative permits to build and operate project facilities, with the notable exception of administrative concessions for some infrastructure projects. These concessions can be mortgaged in accordance with the

7 Most notably, in the aftermath of the 2008 financial crisis, when Spanish banks were subject to massive rating downgrades, sometimes to the point where the new rating was not deemed acceptable for a bank holding the project accounts.

8 Limited liability companies do not issue share certificates. For public limited liability companies, the shares can also be represented by book entries, although these are very seldom used in project finance SPVs.

law on public contracts,[9] but in many cases, again because of the high cost in terms of stamp duties, this is foregone in exchange for a pledge of the concessionaire's credit rights in the event of termination of the concession. Both the mortgage of the concession and the pledge of the concessionaire's credit rights will as a general rule require the consent of the granting authority.

In other sectors where the project company is entitled to receive regulated income (such as with respect to gas transport facilities), a pledge over the project company's credit rights is also granted.

v Sponsor guarantees

Over the past few years, there has been a significant change of trend in the use of completion guarantees. Traditionally, the sponsors would assume the construction risk through completion guarantees. That used to take the form of first demand guarantees, but in recent times several major projects have been financed without the sponsors taking on this risk. Construction risk has rather been allocated in full to the contractors developing the project, either under an EPC agreement or under a multi-contract structure. Whether this is the most efficient allocation of risk remains to be seen.

In fact, we are seeing more aggressive equity structures where, instead of all sponsor equity being disbursed up-front, some sponsors are allowed to disburse their contributions either *pari passu* with debt drawdowns, or even at the end of the construction phase. In these cases, equity guarantees are requested by lenders, either as corporate guarantees from creditworthy group entities, or in the form of bank guarantees; in both cases, when the guarantees are provided to the project company, its credit rights in connection with the same will also be pledged in favour of the lenders.

Foreclosure

The standard way of enforcing security interests under Spanish law is by selling the collateral in a public auction (conducted either before a judge, a notary public or through an electronic platform). The auction proceeds are paid to the secured creditors and, if there is any surplus, it is paid to the pledgor. It is important to point out that, as a general rule, the creditors cannot simply seize and appropriate the assets (*lex comissoria*); there is a long-standing tradition against this practice, associated with predatory lending. In some cases, if an appropriate valuation mechanism is agreed, and the pledgor is granted the right to recover any surplus (*pacto marciano*), it may be possible to agree to the appropriation of the assets by the creditors, but this is still not the general rule.

As an exemption, financial collateral under Royal Decree-Law 5/2005,[10] implementing the EU Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements, does allow the enforcement through appropriation of the collateral, when the security is granted over shares of public limited liability companies or bank accounts (but in this case, a certain amount of 'control' is required over the accounts, for the security to qualify as a financial collateral arrangement).

9 Article 273 of Law 9/2017, of 8 November, on public sector contracts.

10 Royal Decree Law 5/2005, of 11 March, on of urgent reforms to boost productivity and to improve public procurement.

In the case of pledges over receivables, which as we have seen are the most important security interests in the context of project finance, the enforcement is typically carried out by serving a notice (by the security agent) to the debtor of the receivables, instructing it to pay them directly to the security agent, for the account of the secured creditors, and then the creditors' obligation to hand over the monies collected to the project company is set off against the project company's payment obligations under the finance documents. In the case of the project accounts, the balance in those accounts is transferred to the security agent and then set off.

Concerning pledges of shares, the Civil Code does allow the creditors to appropriate the pledged shares if two auctions have not been successful (but in this case they must relinquish all claims to any unpaid amounts).

Intercreditor agreements

Intercreditor agreements are very common to regulate the acceleration of credits, enforcement of collateral and distribution of enforcement proceeds among all creditors involved.

A particular feature of the Spanish market is the insistence of banks providing swaps on being awarded full voting rights in the decision-making process, even before they close out their exposures. This is often a point of friction with other lender groups.

Appendix 1

ABOUT THE AUTHORS

JOAQUÍN SALES

King & Wood Mallesons

Joaquín Sales is partner and head of the banking and finance team of King & Wood Mallesons in Spain. He advises banks, financial institutions and funds, as well as corporations, on all kinds of financing transactions, such as project finance, acquisition finance, corporate and asset finance – as well as on structured finance transactions and securitisation deals, both domestic and international.

Joaquín is recognised as one of the best specialists in banking and finance law in Spain by the main legal directories, including Chambers & Partners, Best Lawyers, The Legal 500 and Leaders League.

KING & WOOD MALLESONS

C/ Goya, 6
28001, Madrid
Spain
Tel: +34 91 426 00 50
Fax: +34 91 426 00 66
joaquin.sales@eu.kwm.com
www.kwm.com

an **LBR** business

ISBN 978-1-83862-816-1