Lender`s Step-in Right Mechanism in Project Financing

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ABSTRACT

This thesis examines the step-in rights of the lender in the context of project finance transactions. Project finance activities are associated with numerous financial risks borne by the lender. The sponsor's failure to complete the project would likely result in a default on the loan due to the inadequacy of the available security package. Hence, it is crucial for the lender to be able to exercise step-in rights—the right to intervene in the project to rectify the problems and prevent the termination of the project agreements.

The thesis undertakes a fundamental approach to examining the main features of the 'step-in' concept. In light of that, it first analyzes the levels of the exercise of step-in rights. Second, it discusses the tools available in different jurisdictions that enable the lender to intervene, thereby providing the building blocks for understanding the possible applications and objectives behind 'step-in'. Third, the focus of the thesis shifts to scrutinising the various contractual arrangements into which step-in is usually incorporated. Furthermore, it situates the ability to step in within the public-private context, where such necessity usually arises for the lender. Thus, without focusing on a specific jurisdiction, the thesis aims to explore the concept of step-in rights at a theoretical level, examining different aspects relevant to its exercise. The thesis delves into both the theoretical foundations of step-in rights and the established practices within the industry. Given the international nature of project finance activities, it also examines various solutions and challenges encountered in various jurisdictions.

1. INTRODUCTION

1.1 Why this topic?

Nowadays, project finance is widely utilized by both, sponsors engaged in the development of private projects, and those involved in cooperation with host governments, typically under Public-Private Partnership arrangements.[1] Reasons underlying the popularity of this technique of financing varies from project to project and depend on the nature of the actors involved.

Thus, numerous governments find themselves either incapable or disinclined to finance projects traditionally conceived within the scope of mandate of public authorities, such as highways, hospitals, or energy networks. The inability to finance large infrastructure and similar projects for the public need can especially be observed in the developing countries, where significant problems with state budget, and inefficiency of the local administrative system create additional hurdles. Moreover, utilisation of project finance allows host governments to develop projects that otherwise may be treated as non-priority ones. Reduction of public sector borrowing requirement, attraction of foreign investors, acquisition of international expertise, and know-how are among the other reasons.

Utilizing foreign finance techniques such as project finance is also advantageous for private, commercially oriented entities. These special arrangements may enable them to avoid consolidating project debt on their own balance sheets.[2] Furthermore, restrictions on borrowing due to financial covenants in loan agreements or limitations stipulated by statutes can also be mitigated through this financing method.

[1] the rise of Public-Private Partnership schemes as one of the methods to finance public infrastructure was observed after the 2007-2008 global financial crisis. See Robert Osei-Kyei and Albert P.C. Chan ‘Review of studies on the Critical Success Factors for Public–Private Partnership (PPP) projects from 1990 to 2013’ (2015) Int. J. Proj. Manag. 1335, 33.
[2] Yunbi An and Keith Cheung, ‘Project financing: Deal or no deal’ (2010) 19 Review of Financial Economics 72.

However, a crucial factor for both private sponsors and those cooperating with local governments is the motivation to insulate themselves from project debt, thereby minimizing the negative consequences in the event of project failure. In other words, risk-sharing is typically the primary incentive for adopting project finance arrangements.

The means through which this goal is achieved implies transferring the portion of liabilities to the party which provides funds for the implementation of the development at stake.[3] Hence, the fundamental essence of project financing lies in the mutual interest of the parties involved, such as the contracting authority or private sponsor, to offload the maximum financial risks onto the financier.[4]

Such an allocation of risks may potentially create certain disincentives for the lender's participation in project finance transactions, encouraging them to opt for less risky investment opportunities. Project finance should act as a catalyst for economic and social advancement in the host country, serving as a reliable safeguard for the sponsors while also delivering benefits to other stakeholders involved. The effective utilization of project financing techniques is only achievable through the active engagement of financing parties. Their willingness to participate in such transactions hinges entirely on their confidence that their commercial interests are adequately protected. Given that project finance transactions are typically perceived as risky for lenders, their ability to engage in such transactions may be compromised. Project finance is characterized by a lack of assurances for lenders that the provided debt will be repaid. This risk stems from the ineffectiveness of the conventional security system in situations where the availability of funds for repayment depends entirely on the future profits generated by the project in the event of its successful realization.

[3] see Esteban C. Buljevich and Yoon S. Park, *Project Financing and the International Financial Markets* (Kluwer Academic Publishers 1999) ch 9, 122.
[4] ibid.

In light of the above, careful consideration should be given to additional measures aimed at safeguarding the interests of lenders. One such measure is the availability of a developed system of step-in rights, granting lenders the ability to intervene or take over control over the project and ensure its completion is not jeopardized. The availability of this system relies on two pillars: contractual arrangements between parties and the regulatory framework in place. The purpose of this thesis is to contribute to existing literature by analyzing the various forms of step-in rights available to lenders, the contractual arrangements that underlie the ability to exercise these rights, and emphasizing the significance of robust private-public partnership laws that incorporate the step-in rights mechanism.

1.2 Research methodology

Project finance arrangements are typically not subject to rigorous sector-specific regulations. Furthermore, despite attempts to incorporate the ability to step in within some national laws regarding public-private partnership, the procedures for exercising this ability remain largely unregulated.[5] As a result, step-in procedures have been predominantly developed in practice by representatives of the involved industries. In view of the above, the thesis will primarily rely on doctrinal research, involving the examination of existing scholarly resources covering the issue. Special attention will be devoted to scrutinizing international and selected domestic sources of law. Emphasis will be placed on developed practices used by representatives of the sectors involved in project finance activities. Additionally, standards and recommendations provided by international organizations and banks will be analyzed as well.

[5] for examples of national laws regulating certain aspects of step-in rights see the Law on Public-Private Partnership (2009) in Latvia, the Law on Concessions (2006) in Lithuania, and the Law on Public-Private Partnership (2016) in Ukraine.

1.3 The roadmap to the thesis

The thesis will start with a general overview of project financing as a type of funding. We will provide the definition of project finance, examining its various components and the risks associated with it. We will explore the concepts of non-recourse and limited recourse financing, as well as the description of the main stages involved in project finance structure will be provided. Additionally, we will justify the significance of step-in rights within the context of project financing.

Our analysis will then shift to a detailed exploration of step-in rights. We will begin by defining the notion of step-in rights and discussing the different levels of lender's intervention at which they operate.[6] This will include an examination of cure rights, step-in rights in the strict sense, and novation. Furthermore, we will investigate the tools available for exercising step-in rights, such as through corporate governance structures, pledge on shares of the project company, transfer of shares via call options, and receivership.

The subsequent chapter will focus on the direct agreement—a key instrument in implementing step-in rights. We will provide a synopsis of the law and practice on direct agreements, including the parties involved and important clauses from the lender's perspective. Additionally, we will address the obstacles that may impede its enforcement. Significance will be attached to the operation of the direct agreement in the context of public-private partnership. In the course of this discussion, the importance of the availability of national legislation will be highlighted. The alternatives to and form of the direct agreement involving contracting authorities will be described. Finally, we will assess the utility of the direct agreement within the framework of project financing.

[6] Jeffrey Delmon and Victoria Rigby Delmon (eds), *International Project Finance and PPS: A Legal Guide to Key Growth Markets* (Kluwer Law International 2012) ch 2, 32.

2. PROJECT FINANCING

This section will provide a definition of project finance. The purpose of clarifying this concept is to draw a line between other similar financing methods, that can be used interchangeably and create confusion due to their similarities. Moreover, understanding of peculiarities and the nature of project finance will underline the significance of existence of the lender`s step-in rights.

2.1 What is project finance?

Project finance is commonly defined as a form of financing wherein the approval of funding is not contingent on the financial stability or creditworthiness of the project sponsor—the party initiating the development of a project.[7] Rather, approval for financing is based on the project's capacity to generate sufficient revenue to repay the debt and provide returns on the invested capital at a rate commensurate with the project's risk level.[8] In other words, it prioritizes the project's ability to generate cash flow over the assets offered by sponsors as collateral.[9]

Defining project finance precisely is challenging due to the absence of universal structures applied uniformly across all transactions.[10] Instead, project finance structures adapt to the unique characteristics and risks of individual projects.[11] The definition offered by John D Finnerty appears to be among the most comprehensive: "Project financing may be defined as the raising of funds on a limited-recourse or nonrecourse basis to finance an economically separable capital investment project in which the providers of the funds look primarily to the

[7] Gatti Stefano, *Project Finance in Theory and Practice - Designing, Structuring, and Financing Private and Public Projects* (2nd edn, Academic Press 2013) ch 1, 1.
[8] ibid.
[9] ibid.
[10] Robert Clews, *Project Finance for the International Petroleum Industry* (Academic Press 2016) ch 1, 6.
[11] ibid.

cash flow from the project as the source of funds to service their loans and provide the return of and a return on their equity invested in the project."[12]

Project finance can be defined by its distinctive characteristics, which, although not necessarily ubiquitous across all financed transactions, are commonly referred to as the most prevalent. One of these defining characteristics involves the presence of special arrangements aimed at limiting the liability of the sponsor. For instance, this is often achieved through the establishment of a special purpose vehicle (SPV).[13] The primary purpose of the SPV is to segregate or securitize assets within a distinct company, which is frequently maintained off the balance sheet. Additional noteworthy feature, which appears consequential to the first, is the expectation that the loan will be exclusively repaid from the future income (receivables) generated by the project.[14] It can be also expressed by the restriction of recourse in such transactions, meaning that the lender has limited claim against the borrower. Another key aspect is that the primary source of financing typically originates from banks, syndicates thereof or financial institutions.[15] Furthermore, project finance primarily encompasses high-profile projects involving numerous participants and intricate networks of agreements.

The following sections will delineate the aspects of project finance that can be considered most relevant to exercising step-in rights.

2.2 Non-recourse and limited recourse

It follows from the definition presented above that the project debt in project financing mostly appears in two forms: nonrecourse and limited recourse. The term "non-recourse" typically

[12] John D Finnerty, *Project Financing: Asset-Based Financial Engineering* (2nd edn, John Wiley & Sons, Inc 2007) 1.
[13] Stefano Gatti, *Project Finance in Theory and Practice: Designing, Structuring, and Financing Private and Public Projects* (Academic Press 2008) 235.
[14] ibid 103.
[15] Graham D Vinter, *Project Finance : A Legal Guide* (3rd edn, Sweet & Maxwell 2006) 176.

denotes a situation where lenders are restricted to seeking repayment solely from specified assets and are prohibited from taking legal or financial action to enforce repayment or obtain redress from the borrower directly under any circumstances.[16] This implies that their sole course of action in case of non-payment is to enforce their security interest.[17] The notion of limited recourse implies that project sponsor provides additional undertaking to supplement security interest in case of default.[18] In project financing, mostly, the nonrecourse borrowing is envisaged to be repaid and covered solely by the cash flow generated by the project.[19]

2.3 Risks in project financing

Given the magnitude, the large number of participants, and unique characteristics of project finance, project finance transactions involve significant risks. These risks can be particularly perilous for lenders.[20] The uncertainties associated with technology, design, and construction often lead to delays or cost overruns, jeopardizing the lender's repayment schedule. Natural resource or raw material shortages can disrupt project operations, affecting cash flow.[21] Operating and management challenges may impact project performance, affecting loan servicing. Transportation logistics problems threaten to hinder supply chain efficiency. Marketing and commercial risks, such as contract disputes or market downturns, can undermine project revenue streams, making loan repayment difficult.[22] Political instability may further exacerbate risks by introducing regulatory changes or project disruptions beyond the lender's control. Additionally, the credit risk of the project company poses the threat of default,

[16] Graham D Vinter, *Project Finance : A Legal Guide* (3rd edn, Sweet & Maxwell 2006) 181.
[17] ibid.
[18] John D Finnerty, *Project Financing: Asset-Based Financial Engineering* (2nd edn, John Wiley & Sons, Inc 2007) 443.
[19] 'Non-Recourse Financing' (Atoll Financial Group) <https://www.atollfinancial.com/non-recourse-financing> accessed 11 March 2024.
[20] David Suratgar, 'International Project Finance and Security for Lenders' (1982) 6 United Nations Sustainable Development Journal 113.
[21] ibid.
[22] ibid.

leaving the lender with potential losses.[23] Accordingly, special attention should be paid to the additional mechanisms by which the rights of the lender can be safeguarded.

2.4 Overview of the process of project finance

To better understand the context of exercising step-in rights, a description of the project finance process is a must. Project financing can be structured in various ways. However, to illustrate how this type of financing works in practice the simplified example below may be of help.

Firstly, the sponsor initiates the formation of a project vehicle (SPV), which serves as the executor of the project. This vehicle may take the form of a legal entity distinct from the sponsor, or a set of contractual arrangements designed to dissociate it from the sponsor's identity.[24] From the sponsor's standpoint, this division aims to minimise financial liability in the event of disruptions. Sponsor can comprise a consortium of legal entities, typically encompassing at least one parent company of the special purpose vehicle.[25]

Subsequently, financiers furnish funding to the aforementioned vehicle. Typically, the security for the loan is established over the assets of the vehicle and the revenues generated by the project slated for implementation.[26] Lenders face a specific risk due to project companies being limited liability entities with minimal nominal share capital.[27] If the project fails to materialize

[23] ibid.
[24] Doug Jones, 'Third-Party Involvement in Construction Projects: The Influence of Financiers' (2013) 8 Const L Int'l 10.
[25] Arman Zenginpedük and Yaman Gürse, 'Overview of Project Finance and As a Security Device "Subordinated Loans" and Its Reflection in Practice under Turkish Law' (2019) <https://dx.doi.org/10.2139/ssrn.3455328> accessed 28 March 2024.
[26] Doug Jones, 'Third-Party Involvement in Construction Projects: The Influence of Financiers' (2013) 8 Const L Int'l 10.
[27] Jörg Böttcher (ed), *Green Banking: Realizing Renewable Energy Projects* (De Gruyter Oldenbour 2020) ch 9, 273.

or fails to generate profits, the project company often lacks the capacity to repay the loan.[28] Consequently, lenders require supplementary security in such instances.[29]

After contractual arrangements with lenders are established, contractors are engaged through the established vehicle to execute the planned project.[30] Frequently, contractors assume roles beyond that of independent service providers, instead becoming stakeholders within the Special Purpose Vehicle (SPV).[31] This involvement extends to their contribution to project financing through equity stakes.[32] Equity participation offers an advantage by fostering closer alignment between contractors like Design-Build or Operations and Maintenance contractors with the project.[33] As a result, they are more inclined to adhere diligently to the agreed plan and schedule.[34] This alignment of interests helps mitigate the inherent risks associated with project failure.[35]

Finally, the loan is repaid and serviced using the cash flow generated by the project. Any surplus profits are distributed to the sponsors.[36]

2.5 Justification of the importance of step-in rights in project financing

As can be concluded from the above, the existence of step-in rights can be justified by three main reasons: a) a loan is extended to a company whose creditworthiness cannot be assessed due to the absence of a credit history; b) the loan is granted on a non-recourse basis; and c) the completion of the project is exposed to various risks beyond the lender's control. In the case of

[28] ibid.
[29] ibid.
[30] ibid.
[31] Zeina Malaeb and Farook Hamzeh, 'A Lean Perspective of Stakeholder Integration in Public Private Partnerships' (2018) 26th Annual Conference of the International Group for Lean Construction 3, 5 <doi.org/10.24928/2018/0217> accessed 01 June 2024.
[32] ibid.
[33] ibid.
[34] ibid.
[35] ibid.
[36] Jörg Böttcher (ed), *Green Banking: Realizing Renewable Energy Projects* (De Gruyter Oldenbour 2020) ch 9, 273.

default on the loan, the lender usually cannot rely on any sources of repayment other than the profits generated by the project. It is in the lender's best interest to have the ability to intervene in the project and ensure its smooth completion and functioning. This explains the importance of the concept of step-in rights in high-risk lending, such as project financing.

3. STEP-IN RIGHTS

This chapter aims to elucidate the significance of step-in rights within the framework of project finance. It will offer a theoretical overview of the lender's levels of intervention in project activities through their exercise of these rights. The primary focus will be on delineating the practical mechanisms by which lenders can effectively implement their step-in rights.

3.1 Notion of step-in rights

Step-in rights can be defined as the lender's right to assume control over the project company under pre-agreed circumstances.[37] For lenders stepping in typically entails the ability to assume the position of their borrower if the borrower defaults under the relevant contract. This provision is typically temporary, aiming to provide lenders stepping in with the opportunity to address the default and prevent contract termination.[38]

3.2 Levels of step-in rights

According to Jeffrey Delmon, step-in rights can be categorized into three different levels, depending on the scale of the lender's intervention in the project activity.[39] The described types are cure rights, step-in rights in the strict sense, and novation or substitution.[40] It should be noted that in practice, it is often difficult to draw a line between the proposed levels. Step-in rights may overlap, be used cumulatively, or the initiation of one level may inevitably lead to the application of a deeper intervention.

[37] Farid Mohamadi, *Introduction to Project Finance in Renewable Energy Infrastructure: Including Public-Private Investments and Non-Mature Markets* (Springer International Publishing 2021) 247.
[38] 'Guidance on PPP Contractual Provisions' (International Bank for Reconstruction and Development/The World Bank 2019) <https://consultations.worldbank.org/en/consultations/detail/guidance-ppp-contractual-provisions> accessed 25 March 2024.
[39] Jeffrey Delmon and Victoria Rigby Delmon (eds), *International Project Finance and PPS: A Legal Guide to Key Growth Markets* (Kluwer Law International 2012) ch 2, 32.
[40] ibid.

3.2.1 Cure rights

Cure right of the lender is a type of step-in right which entails the lender's ability to fulfil the specific borrower's obligations in order to save the contract.[41] Upon the notification of the breach of the contract, every project participant must provide lenders with the chance to resolve the issue.[42] If lenders fail to act within the agreed cure period, the affected participant can seek contractual remedies.[43] Lenders often focus on breaches related to payment obligations and may choose to rectify them first, particularly if they involve monetary payments and the project company is otherwise performing well.[44] For instance, a situation requiring the use of cure rights may occur when the project company constructing a pipeline falls behind on payments to its contractor for construction services.[45] The lender has the option to intervene by directly settling the overdue amount with the contractor, bypassing the project entity.[46] Such actions would maintain project continuity and mitigate potential disruptions in project execution. Worth noting, the exercising of cure rights does not amount to a change in control over certain project contracts since the cure step-in is temporary and does not transfer liability from the initial obligor to the lender.

3.2.2 Step-in rights in the strict sense

Step-in rights, in their strict sense, are activated when one of the project participants decides to terminate the contract due to a breach by the project company.[47] Lenders then have the option

[41] Wei Lim, David Gilham, Kirby Jukes, Amy Tin, McCullough Robertson 'Side deeds: what, when and why?' (2020) <https://uk.practicallaw.thomsonreuters.com/w-023-7938?transitionType=Default&contextData=(sc.Default)&firstPage=true> accessed 08 April 2024.
[42] Jeffrey Delmon and Victoria Rigby Delmon (eds) *International Project Finance and PPS: A Legal Guide to Key Growth Markets* (Kluwer Law International 2012) ch 2, 32-33.
[43] ibid.
[44] ibid.
[45] Murat Madykov, 'Step-in Right as a Lender Protection Mechanism in Project Financed Transactions' (2015) 13 DePaul Business and Commercial Law Journal 273.
[46] ibid.
[47] Jeffrey Delmon and Victoria Rigby Delmon (eds), *International Project Finance and PPS: A Legal Guide to Key Growth Markets* (Kluwer Law International 2012) ch 2, 34.

to step in alongside the project company, rectify the breach, and restore project operations.[48] Other participants must maintain contractual ties with the substitute entity rather than the project company, which remains obligated under the project documents. These step-in rights apply to all project documents, ensuring comprehensive coverage.[49] If the lender's efforts to rescue the project prove futile, it has the option to step-out by either notifying subcontractors or failing to transfer the project contract to a third party before the step-in period ends.[50] In this case, the additional obligor's liability is limited to paying for the work or services performed by subcontractors during the step-in period, subject to specified liabilities.[51]

3.2.3 Novation

This level of step-in entails the biggest changes in the project management.[52] In a novation, the project company is completely replaced in the project contracts. In this scenario, all of the project company's rights and obligations are transferred to a substitute entity.[53] A substitute party assumes full responsibility for fulfilling the project company's obligations and becomes solely liable thereafter.[54] Before lenders can successfully complete the novation process, the concession agreement, along with all other project documents and licenses or permits, must either provide for novation or be renegotiated.[55] Additionally, the various project participants may need the right to approve the substitute entity, although they should not unreasonably

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[48] ibid.
[49] ibid.
[50] Martin Preston, 'Direct agreements help protect lenders' (2010) <http://80.241.146.114/gulfconstruction/news/11921_Direct-agreements-help-protect-lenders.html> accessed 08 April 2024.
[51] ibid.
[52] Jeffrey Delmon and Victoria Rigby Delmon (eds), *International Project Finance and PPS: A Legal Guide to Key Growth Markets* (Kluwer Law International 2012) ch 2, 33.
[53] Carla Milani do Prado Rossi, 'Step-in Rights Mechanisms in Project Finance Transactions and Lenders' Liabilities – the English and Brazilian Legal Approaches' (2018) FGV Direito SP Research Paper Series n. 160, <http://dx.doi.org/10.2139/ssrn.3144346> accessed 28 March 2024.
[54] ibid.
[55] Jeffrey Delmon and Victoria Rigby Delmon (eds), *International Project Finance and PPS: A Legal Guide to Key Growth Markets* (Kluwer Law International 2012) ch 2, 33.

delay or withhold such approval.[56] The substitute entity is typically a nominee chosen by the lenders or a trade buyer showing interest in the project, but it's uncommon for the lenders themselves to take on this role.[57] The key difference between the step-in types enumerated before and novation is that in the former, the project company retains responsibility for its obligations, which protects the lenders' nominee from project-related liabilities and increases the possibility of finding a suitable replacement.[58]

3.3 Tools for exercising step-in rights

In practice, lenders possess a range of tools to implement their step-in rights, contingent upon regulatory constraints and contractual terms. Depending on the jurisdiction, various methods can be used to save the project or the agreements underlying it. Below, a list of some of these methods will be proposed. It is important to note that the list is not exhaustive and can be further supplemented. Among the available tools for exercising step-in rights, the following are worth mentioning: 1) step-in through a corporate governance structure; 2) step-in by enforcing a pledge on the shares of the project company; 3) transfer of shares by means of call-option; and 4) appointment of a receiver.

3.3.1 Step-in through a corporate governance structure

Potential methods for stepping in through a corporate governance structure include (i) the assignment of voting rights to the lender (by shareholders or board members), (ii) granting the authority to appoint directors to the board, and (iii) granting veto rights over key matters to the

[56] ibid.

[57] Sabina Axelsson, 'Project Finance and the Efficiency of Direct Agreements Under Swedish Law – the Treatment of the Debtor's Contracts in Bankruptcy', (LLB thesis, Göteborg University 2006) 9.

[58] Alexei Zverev ed, EBRD PPP Regulatory Guidelines Collection (vol I, ch 12, European Bank for Reconstruction and Development 2024) 5</chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/file:///C:/%D1%81%20%D0%B4%D0%B8%D1%81%D0%BA%D0%B0%20E/ceu/thesis/litrerature/VOLUME1-web+(2)%20(1).pdf> accessed 19 May 2024.

lender.[59] It is crucial to emphasize that these tools of stepping-in are not typically perceived as conventional. The rationale for such an extension can be found in the notion of control, which is not limited to financial ownership.[60] In accordance with the interpretation of control proposed by Berle and Means, control shall be defined as the capacity to make decisions regarding all critical aspects of a company's operations.[61] Consequently, this definition distinguishes control from ownership and management.

Earlier, the assignment of voting rights without transferring economic control was perceived as not feasible. The prevailing concept in the market was that a "shareholder" possessed both economic ownership and voting power.[62] In the past, Delaware courts viewed shareholders as owners and voters, forming the core basis for managerial authority over corporate assets.[63] However, the assumption that voting rights are closely tied to economic interests is becoming less common.[64] The rise of derivatives in finance, particularly the expansion of equity swaps and other "over the counter" equity derivatives, along with the growth of the stock lending market, has significantly facilitated and reduced the cost of separating economic ownership from voting rights.[65]

[59] Carla Milani do Prado Rossi, 'Step-in Rights Mechanisms in Project Finance Transactions and Lenders' Liabilities – the English and Brazilian Legal Approaches' (2018) FGV Direito SP Research Paper Series n. 160, <http://dx.doi.org/10.2139/ssrn.3144346> accessed 28 March 2024.
[60] Carla Milani do Prado Rossi, 'Step-in Rights Mechanisms in Project Finance Transactions and Lenders' Liabilities – the English and Brazilian Legal Approaches' (2018) FGV Direito SP Research Paper Series n. 160, <http://dx.doi.org/10.2139/ssrn.3144346> accessed 28 March 2024.
[61] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (Transaction Publishers 2004) 66.
[62] Henry T. C. Hu, Bernard Black, 'Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms' (2006) 61 The Business Lawyer 1011.
[63] See Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988); cf. MM Companies Inc. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003).
[64] Henry T. C. Hu, Bernard Black, 'Empty Voting and Hidden Ownership: Taxonomy, Implications, and Reforms' (2006) 61 The Business Lawyer 1011.
[65] Henry T. C. Hu, 'Behind the Corporate Hedge: Information and the Limits of "Shareholder Wealth Maximization,"' (1996) 9 J. APPLIED CORP. FIN. 39.

Thus, as the perception of control shifted, lenders gained a new means of intervention in the project. This wasn't achieved through acquiring economic ownership but rather by assuming control over the decision-making process.

3.3.2 Pledge on the shares of the project company

As part of the security arrangement, shareholders might be requested to pledge their shares in the project company to the project lenders. This security interest primarily serves to provide lenders with the option to assume control of the project in case of financial distress.[66] Usually, the right to pledge shares is not merely a contractual stipulation; local laws must also provide for the ability to pledge the shares. The underlying logic is as follows: the lender, through the transfer of shares, will acquire voting rights. These voting rights may be used to change the management of the project company.[67]

The scenario underlined above can be realised if the relevant security law grants ownership rights to the pledgee. This would authorize project lenders to step into shareholders' rights upon default under the project loan agreement and replace the project company's management.[68] However, enforcing the pledge on shares by the lender in the event of the debtor's default, resulting in the lender obtaining full ownership of the shares and the right to vote them, is usually not allowed. This limitation is typically evident in civil law legal systems and stems from the Roman principle on the prohibition of lex commissoria.[69] The main goal of the ban on out-of-court enforcement of the pledge by the creditor is to protect the debtor, who typically

[66] Peter K. Nevitt, Frank J., Fabozzi *Project Financing* (7th edn, Euromoney Books 2000) 52.
[67] Maria Ataíde Cordeiro, 'Portugal: Banks' Step-In Rights under the Portuguese Public Contract Code: Exercise by Means of Transfer of Shares' (2011) 6 (3) European Procurement & Public Private Partnership Law Review 164.
[68] Philip R Wood, *Project Finance, Subordinated Debt and State Loans*, (Sweet & Maxwell 1995) 30.
[69] Marko Sukačić, 'Lex commissoria: from a Forbidden Clause in Roman Law to a (Contemporary) Debtor's Welcome Relief' (2021) 12 2 Journal on European History of Law 96.

has weaker bargaining power compared to the creditor.[70] It also serves to prevent the unjust enrichment of the creditor by the sale of the encumbered asset, which commonly holds a higher value than the debt granted.[71] Depending on the legal system, the application of the lex commissoria ban typically results in transactions involving the appropriation of encumbered assets by the creditor being rendered null and void.[72] Additionally, any contractual provisions allowing the creditor to appropriate the assets without complying with legal formalities would also be invalidated.[73] For instance, under German law, the agreement to transfer the ownership of the pledge to the creditor before the debt has become due is void.[74]

It is true that in certain jurisdictions, when shares are pledged as collateral for a loan, the lender's ability to take control of the company if the borrower defaults might be limited. This limitation arises from the requirement that the lender can only sell the pledged shares through a legal process overseen by the court, known as a judicial sale.[75]

The situation in which a pledge on shares may not be sufficient to establish control over the decision-making process of the entity in civil law jurisdiction is well-illustrated by the decision of the Lithuanian Supreme Court in the case of E. Tvarijonavičienė v. AB Malsena.[76] There, the plaintiff pledged the company's shares.[77] Upon the default of one of the shareholders on his

[70] Magdolna Sič, 'Remarks on the Reasons of Commissoria Rescindenda' (2014) 3 1 Scientific Journal of Sapientia University 91, 92.
[71] Bénédict Foëx, Pascal Pichonnaz and Denis Piotet (eds), *Commentaire Romand-Code Civil II* (Helbing & Lichtenhahn 2016) 2453.
[72] Yaman Gürsel, 'Civil Law (Mainly Turkish and Swiss Law) Approaches to the Prohibition of Pactum Commissorium and a Brief Overview to Implementation of the Pactum Commissorium Under Common Law' (2019) Bahçeşehir Üniversitesi Hukuk Fakültesi Dergisi.
[73] ibid.
[74] § 1229 German Civil Code (2002) <https://www.gesetze-im-internet.de/bgb/__1229.html#:~:text=B%C3%BCrgerliches%20Gesetzbuch%20(BGB),%C3%BCbertragen%20werden%20soll%2C%20ist%20nichtig.> accessed 11 June 2024.
[75] Tero Erme, 'International Project Financing as Contractual Risk Minimization Arrangements' (2000) Helsingin yliopiston kirjaston verkkojulkaisu 279.
[76] Civil case E. Tvarijonavičienė v. AB Malsena, No. 3K-334/2004, Lietuvos Respublikos Aukščiausiasis Teismas [Supreme Court of the Republic of Lithuania], 16 July 2004, cited in "Teismų Praktika" No. 22.
[77] Stefan Messmann, Tibor Tajti (eds), *The Case Law of Central and Eastern Europe Enforcement of Contracts,* vol 1 (European University Press 2009) 376-378.

obligations, the security interest was enforced, and the shares were transferred to the creditor.[78] Following the transfer, a shareholders' meeting was convened.[79] However, the plaintiff was denied his right to vote because his name was not listed in the register of shareholders maintained by the company's securities administrator.[80] The voting rights were exercised by the debtor, whose shares had already been transferred.[81] The creditor contested the decision through the judicial system, ultimately reaching the Supreme Court.[82] The court held that the entry of the pledged shares into a securities account in the name of the pledgee constitutes a transfer of possession, but does not confer ownership.[83] Consequently, the court concluded that merely possessing the shares did not entitle the plaintiff to manage the collateral or utilize the shares for profit.[84] Although Lithuanian law permits the debtor and creditor to agree on the terms of the transfer, including the transfer of ownership, no such agreement was reached.[85] As a result, the plaintiff was denied his right to exercise the voting rights associated with the shares.

The problem described above could be tackled by selling the shares to the entity connected to the creditor. However, this process can be complicated by regulations against "self-dealing." "Self-dealing" refers to situations where the lender sells the pledged shares to themselves or to someone closely connected to them.[86] In jurisdictions with such regulations, this practice is

[78] ibid.
[79] ibid.
[80] Legal Research Group of the Supreme Court of Lithuania 'Overview of the Practice of the Supreme Court of Lithuania Regarding the Implementation of Shareholder Rights and Methods of Their Defense' (2019) 53 <https://www.lat.lt/data/public/uploads/2019/06/2019_akcininko-teisiu-igyvendinimo-apzvalga.docx> accessed 18 May 2024.
[81] Civil case E. Tvarijonavičienė v. AB Malsena, No. 3K-334/2004, Lietuvos Respublikos Aukščiausiasis Teismas [Supreme Court of the Republic of Lithuania], 16 July 2004, cited in "Teismų Praktika" No. 22.
[82] ibid.
[83] Legal Research Group of the Supreme Court of Lithuania 'Overview of the Practice of the Supreme Court of Lithuania Regarding the Implementation of Shareholder Rights and Methods of Their Defense' (2019) 53 <https://www.lat.lt/data/public/uploads/2019/06/2019_akcininko-teisiu-igyvendinimo-apzvalga.docx> accessed 18 May 2024.
[84] Laurynas Didžiulis, *Contract Law in Lithuania* (2nd edn, Kluwer Law International 2023) para 435.
[85] Article 4.219 (5) Civil Code of the Republic of Lithuania (2000) <https://e-seimas.lrs.lt/portal/legalAct/lt/TAD/TAIS.245495> accessed 18 May 2024.
[86] ibid.

prohibited to prevent conflicts of interest and ensure fairness in dealings involving pledged shares.[87] Therefore, in these jurisdictions, achieving the objective of controlling the company through enforcement of a security interest on pledged shares may be difficult due to legal restrictions created by prohibition of lex commissoria, and based on company law restrictions on self-dealing.[88]

The general rule under the US law, is that the right to vote may be exercised by pledgee only in the case when the shares were transferred in its name.[89] For instance, under California law, the pledgor is entitled to exercise voting rights until the shares have been transferred into the name of the pledgee.[90]

Attention should also be paid to the fact that in cases of enforcing a security interest over debtors' shares in jurisdictions where ownership transfer is allowed, the ownership of these equity holdings could entail not only rights but also certain liabilities.[91] These may include voting rights, dividend entitlements, and shareholders' obligations.[92] The transfer of liability from the project company to the lender cannot be seen as the primary intention of the lender. Therefore, the enforcing a security over debtor`s shares extends beyond the traditional understanding of step-in, and it may be less beneficial to the lender.

It's essential to emphasize that enforcing a security interest on shares diverges from the conventional understanding of step-in rights. Nonetheless, its fundamental purpose remains

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[87] ibid.
[88] ibid.
[89] see Italo Petroleum Corp. v. Producers' Oil Corp., 174 A. 276, 280 (Del. Ch. 1934); Gow v. Consolidated Coppermines Corp., 165 A. 136, 148 (Del. Ch. 1933);
[90] Act of June 12, 1931, ch. 862, 1931 Cal. Stat. 1762, 1781 (enacting Cal. Civil Code § 320b(I)).
[91] S. Summerfield and B. McKenzie, 'Shareholders' Rights in Private and Public Companies in the UK (England and Wales): Overview' (2015) Thomson Reuters: Practical Law <https://uk.practicallaw.thomsonreuters.com/5-6133685?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1> accessed 28 March 2024.
[92] ibid.

unchanged: ensuring the continuity of the financed project. Therefore, it is appropriate to consider it as a method of exercising step-in authority.

3.3.3 Transfer of shares by means of call-option

Call-option is another way of transferring shares from the defaulting project company to the lender. The call option is an agreement between the lender and shareholders of the project company.[93] This agreement stipulates that in the event of the project company's default, the lender has the right to exercise the call option.[94] If banks choose to exercise this option, they can purchase all the shares in the project company.[95] From the shareholders' standpoint, they agree to a promise of sale under a condition precedent.[96] This means that in case of default and if the call option is exercised, shareholders are obligated to sell their shares in the company to the banks.[97]

In these circumstances, banks must decide whether (i) to exercise the call option to become shareholders of the project company, (ii) to exercise the call option and become new shareholders to sell the shares to a third party appointed by them, or (iii) to sell the call option to a third party appointed by them instead of exercising it.[98]

According to Maria Ataíde Cordeiro, exercising the call option on shares is a more flexible tool than pledging shares from the lender's perspective.[99] The first reason is that a call option is purely a contractual mechanism, which allows stipulating the moment of transition of voting power, unlike pledging, which is heavily regulated by law if not enhanced by additional

[93] Maria Ataíde Cordeiro, 'Portugal: Banks' Step-In Rights under the Portuguese Public Contract Code: Exercise by Means of Transfer of Shares' (2011) 6 (3) European Procurement & Public Private Partnership Law Review 164.
[94] ibid.
[95] ibid.
[96] ibid.
[97] ibid.
[98] ibid
[99] ibid.

contractual arrangements.[100] It enables banks to step in quickly and effectively without having to comply with the legal requirements set out in the legislation applicable to the financial pledge of shares.[101] The lender can exercise a call option without fulfilling the requirement of terminating the finance agreement or project contract, aligning with the main goal of stepping in, which is to preserve contractual relationships. Generally, since the financial pledge of shares is a security, its enforcement does not allow the lender to intervene on a temporary basis.[102] At the same time, if banks opt to exercise the call option, they can subsequently choose to step out. Alternatively, they can enforce the financial pledge of shares in case of an ongoing default scenario.[103]

However, it's crucial to consider the potential risks for the lender entailed by conclusion of the option agreement. Rights conferred on shares through such contractual arrangements are considered in personam. Consequently, there is a possibility that these rights may be jeopardized in the event of bankruptcy. This risk is evidenced by the position taken in the case law of US courts, where, under certain circumstances, option agreements are classified as executory contracts. As a general rule, §365 of the Bankruptcy Code permits a debtor to either assume or reject the majority of executory contracts.[104] *In re RoomStore Inc.*, the court treated an option contract as an executory one.[105] The case involved RoomStore and Raymond Bojanski, that formed a limited liability company called Mattress Discount Group (MDG). Later, they entered into a "buy-sell" agreement which allowed MDG to purchase the interest of any member who filed for bankruptcy.[106] RoomStore, after filing for bankruptcy, argued that this agreement was an executory contract that could be rejected, stating MDG was profitable

[100] ibid.
[101] ibid.
[102] ibid.
[103] ibid.
[104] 11 U.S.C. § 365.
[105] In re RoomStore, Inc., 473 B.R. 107 (Bankr. E.D. Va. 2012).
[106] ibid.

and its interest was vital to the bankruptcy estate.[107] However, MDG and Bojanski opposed this, citing cases where similar contracts were considered non-executory. The bankruptcy court sided with RoomStore, considering factors such as ongoing obligations and the importance of MDG's assets to the estate.

3.3.4 Receivership

A floating charge under English law has historically been favored for project financing, enabling the out-of-court appointment of an administrative receiver to manage a defaulting project company on behalf of a lender upon default.[108]

A floating charge is a type of security interest that extends over all of the debtor's assets, save the fixed ones that are normally covered by fixed charges at the same time, without restricting the debtor's ability to deal with those assets freely.[109] Romer LJ of the Court of Appeal thoroughly characterized the floating charge by delineating three key elements: Firstly, it encompasses a charge (i.e., a security interest) on a class of assets, both present and future. Secondly, assets within this class may be substituted in the course of the company's regular business operations. Thirdly, the company retains the ability to utilize these assets in its business activities with minimal constraints.[110]

Receivership is initiated by the floating charge holder which has the right to appoint an insolvency practitioner to manage the company.[111] Importantly, the company does not need to

[107] ibid.
[108] Jan-Hendrik Röver, 'Security in project finance and PPP and the implications for secured transactions law: "Security is a shield, not a sword"' in Frederique Dahan (ed), *Research Handbook on Secured Financing in Commercial Transactions* (Edward Elgar Publishing 2015) 241-242.
[109] Phillip R Wood, *Comparative Law of Security Interests and Title Finance. Law and Practice of International Finance* (2nd ed, Sweet & Maxwell 2007) para 22-019.
[110] In re Yorkshire Woolcombers Association Ltd. (1903) 1 Ch 284.
[111] Project Finance 2021: A practical cross-border insight into project finance (10th ed, Global Legal Group Ltd, 2021) 50 <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.milbank.com/a/web/153184/PF21-Chapter-6-England-and-Wales.pdf > accessed 09 April 2024.

be insolvent for this appointment.[112] Instead, an event of default outlined in financial documents must occur.[113] The purpose is to apply either the company's income or the proceeds from the sale of its business toward settling the secured debt. A distinctive aspect of receivership is that the receiver, considered the debtor's agent, primarily owes obligations to the creditor with the security interest, the lender.[114] This means that the receiver may opt to handle the company or its assets in a manner that could negatively impact subordinate claimants, as long as these actions serve the interests of the chargee.[115] Another important feature that renders the English floating charge more advantageous in the context of step-in compared to the instruments available in other jurisdictions is its enforcement regime. It allows for the out-of-court appointment of the receiver by the holder of a qualifying floating charge.[116] The document which allows for such an appointment is called an "instrument".[117] An "instrument" refers to a formal legal document in written form, including deeds, wills, debentures, and floating charges. This document usually delineates the powers of the receiver in accordance with which he shall act, albeit they do not contradict the powers vested by statute.[118] Out-of-court enforcement offers the lender numerous advantages. Firstly, it allows for the prompt takeover of control of the company by avoiding lengthy judicial proceedings, which is extremely relevant for saving the project. Secondly, out-of-court enforcement is more cost-effective, as it helps save on legal fees and court costs. Following the reform of the English Enterprise Act 2002, the appointment of an administrative receiver is now limited to exceptional circumstances. Despite the changes, for project financing, administrative receivers

[112] ibid.
[113] Project Finance 2021: A practical cross-border insight into project finance (10th ed, Global Legal Group Ltd, 2021) 50 <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.milbank.com/a/web/153184/PF21-Chapter-6-England-and-Wales.pdf > accessed 09 April 2024.
[114] ibid.
[115] Rizwaan Jameel Mokal, 'Administrative Receivership and the Floating Charge' in Rizwaan Jameel Mokal *Corporate Insolvency Law: Theory and Application* (Oxford 2004) 209.
[116] Insolvency Act 1986, ss 33-34.
[117] Insolvency Act 1986, s 33.
[118] Insolvency Act 1986, s 42.

can still be appointed under specific conditions. These conditions include a minimum loan size of £50 million and the inclusion of step-in rights in the project structure.[119] One of the reasons behind this exemption was that prohibiting the appointment of an administrative receiver would increase securitization costs, resulting in higher prices for project loans.[120] Moreover, it would deter private investors from investing in public infrastructure.[121] To conclude, for the reasons outlined above, the appointment of a receiver can be considered an effective method for the lender to step in.

Some cautions should still be given for using the receivership as an instrument for step-in rights. It is important to be aware that under English law, a receiver becomes personally liable for any contracts concluded before the commencement of his office. This position was adopted by the court in Powdrill v. Watson.[122] There, an administrator in the insolvency case declared that he would continue to pay employees under employment contracts but was not assuming personal liability.[123] The court disagreed, emphasizing that when the conduct of the administrator or receiver showcases treatment of the contract as adopted, the liability arises.[124] Namely, since an administrator persisted with an employee's employment contract for over 14 days, he effectively adopted that contract.[125]

However, using a floating charge in civil law jurisdictions presents a challenge. While some security devices may seem similar to common law concepts like mortgages and assignments, a closer look reveals significant differences in how lenders can enforce these securities. Importantly, civil law systems lack an equivalent mechanism to the common law's right to

[119] Hugh Beale, Michael Bridge, Louise Gullifer and Eva Lomnicka, *The Law of Security and Title-Based Financing* (2nd ed, Oxford 2012).
[120] Graham D. Vinter, Gareth Price, David Lee, *Project Finance* (4th edn, Sweet & Maxwell 2013) 291.
[121] ibid.
[122] [1995] UKHL J0316-16.
[123] ibid.
[124] ibid.
[125] ibid.

appoint a receiver and empower them as the borrower's representative.[126] Moreover, even if the opportunity to appoint a receiver exists, typically, this step would pose certain risks in jurisdictions lacking a long history of utilizing receivership laws. This can be attributed to the absence of training programs for receivers, their inadequate qualifications, and insufficient knowledge to effectively manage the company. The conclusion can be drawn that receivership can be risky to utilize in highly international project finance transactions, particularly when English law is not applicable as the governing law of the contract.

[126] Roger S. McCormick, ‘Legal Issues in Project Finance’ (1983) 1 Journal of Energy & Natural Resources Law 21, 35.

4. DIRECT AGREEMENT

This Chapter will offer a comprehensive description of the primary contractual tool governing the lender's step-in rights and will delineate the conditions necessary for their enforcement. It will delve into the significance of the direct agreement, providing a thorough explanation of its meaning. Additionally, it will enumerate the parties involved in the direct agreement. Furthermore, it will underscore and describe the crucial clauses upon which the effectiveness of exercising step-in rights hinges. Further, the thesis will place direct agreement in the context of private-public partnership, highlighting the regulatory and signing features, considering the involvement of a contracting authority. The utility of the direct agreement from the lender's perspective will be critically assessed.

4.1 Notion of the direct agreement

Direct agreement is a tool available for lender to maintain the structure of the project agreement and establish direct contractual relations with a project counterparty. The step-in process is typically governed by this agreement. However, it is also possible to negotiate the step-in within the financing agreement itself. [127] In such instances, advance approvals from counterparties would be necessary.

In essence, direct agreements indicate approval of the collateral assignment of the project agreement.[128] The project counterparty acknowledges and accepts the security interest in the borrower's rights to the project agreement, which has been conferred to the lender via a

[127] Graham D. Vinter, Gareth Price, David Lee, *Project Finance* (4th edn, Sweet & Maxwell 2013) 307-341.
[128] David Armstrong and Anna Burke, 'Lenders' Relationships with Project Counterparties' (2022) 4th edn, The Project Finance Law Review 7 <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.skadden.com/-/media/files/publications/2022/06/lenders_relationships_with_project_counterparties.pdf?rev=7ac70ee1acd14f9c93d5094bddae34ab> accessed 25 March 2024.

security agreement.[129] Although project agreements might permit collateral assignment, lenders usually seek a direct agreement that explicitly consents to the assignment.[130] Consequently, these agreements act as collateral documents and are subject to the provisions of the credit agreement.[131]

There are certain doubts regarding which category of project finance contracts the direct agreement should be classified under. It can be referred to as either project contracts or financing documentation. Negotiations of the direct agreement typically occur simultaneously with the project contract. Furthermore, it is traditionally included as an annex to it.[132] Thus, in terms of form, it is more logical to refer direct agreement to project documentation, but in terms of content, it is more similar to financial papers, as it usually specifies the consequences of non-payment of a loan.

The function of direct agreement is both defensive and aggressive. As a defensive tool it helps to shield the lender against abrupt termination of a project contract by a counterparty.[133] It also serves an aggressive function by enabling lenders to assume the project company's rights under the project agreement.[134] Considering the flexibility of a direct agreement as a contractual instrument, it possesses the capability to encompass all the mechanisms permitted for step-in, as outlined in the preceding chapter. Consequently, it can delineate a procedural framework for exercising cure rights or pledging company shares, contingent upon contractually stipulated conditions.

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[129] ibid.
[130] ibid.
[131] ibid.
[132] E. R. Yescombe, *Principles of Project Finance* (2nd edn, Academic Press 2014) 194.
[133] Philip R Wood, *Project Finance, Subordinated Debt and State Loans*, (Sweet & Maxwell 1995) 32.
[134] ibid.

4.2 Parties to the direct agreement

The composition of the parties to a direct agreement depends on the nature of the project. In particular, the list of parties varies depending on whether the project is fully private initiative or is exercised in public-private partnership context. To generalise, the parties could be named as follows: security agent appointed by lenders, project company, or counterparty to the assigned commercial contract. [135] The examples of a contract might include the main construction contract, operation and maintenance agreement, supply and sales contract concluded for long term.[136] In the case of private-public partnership the public authority giving the consent on implementation of the project can be another party.[137]

4.3 Important clauses of the direct agreement from the lender`s perspective

Among the crucial clauses of the direct agreement, the consent given by the counterparty to the project company to use its rights under the relevant contract as collateral can be emphasized.[138] An illustrative example can be the acknowledgment by the offtaker of a pledge over the credit rights arising in favor of the borrower under the virtual power purchase agreement, made in favor of the lender. Here, the counterparty usually confirms that it has not received any notice of any other security interest granted over the same rights. It also undertakes not to consent to the assignment, sale, transfer, disposition of or creation of any form of lien, pledge, charge or encumbrance over the rights at stake without authorisation by the lender.[139]

[135] 'Negotiating Direct Agreements' (Hunton Andrews Kurth) <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.huntonak.com/images/content/7/1/v4/71706/Negotiating-Direct-Agreements.pdf> accessed 27 April 2024.

[136] Graham D Vinter, *Project Finance : A Legal Guide* (2nd edn, Sweet & Maxwell 1998), 159.

[137] ibid.

[138] ibid, 160.

[139] The analysis of the confidential Direct Agreement related to the Virtual Power Purchase Agreement entered into by the borrowers, the lender, and the buyer. The Direct Agreement relied upon is utilized and tested in practice for renewable energy project financing.

Typically, in a direct agreement, lenders are usually granted the right to receive direct notification about any circumstances that warrant contract termination.[140] In practice, this can be insured by the way of a two-fold notification system which the counterparty undertakes to exercise under the direct agreement. Firstly, the counterparty issues the "pre-notice of restricted action" to the lender, while simultaneously providing a copy to the project company. This pre-notice outlines the reasons why a right to undertake a restricted action might be initiated if the project company fails to remedy a default in its obligations as stipulated under relevant commercial contract.[141] Secondly, if the issue is not cured, the party undertakes to issue a “Notice of Restricted Action”. This is the ultimate notification which provides reasonable details about the events or circumstances that have led to the issuance of the notice. It also specifies the exact restricted action that the counterparty intends to take, along with the proposed date for executing this action.[142]

The definition of restricted actions in the direct agreement is crucial for the lender's ability to ensure the efficient execution of step-in rights in the future. The term "restricted action" typically refers to any measures undertaken by the counterparty that directly or indirectly lead to the interruption of project implementation. These actions may include suspending the fulfilment of any obligations specified in the commercial contract at stake. Under this notion, any attempts to terminate, rescind, or acknowledge a purported repudiation of this contract would fall. The term also encompasses the initiation of court proceedings, including enforcement actions, against the project company or any of its assets, as well as instigating the

[140] Gatti Stefano, *Project Finance in Theory and Practice - Designing, Structuring, and Financing Private and Public Projects* (2nd edn, Academic Press 2013) ch 7, 305.
[141] The analysis of the confidential Direct Agreement related to the Virtual Power Purchase Agreement entered into by the borrowers, the lender, and the buyer. The Direct Agreement relied upon is utilized and tested in practice for renewable energy project financing.
[142] ibid.

winding up, dissolution, administration, or reorganization of the project company, and filing for any other available bankruptcy proceeding.[143]

Another important provision to include in the direct agreement is “step-in decision period”. This period usually is not lengthy, around 30 days, and is given for the lender to prepare for exercising its step-in rights. Important feature of this term is that the counterparty is prohibited to perform any restricted actions within it. Moreover, it is ordinary provided that the counterparty will continue to perform its obligations under the contract. It also will be expected to accept cure of any breach or failure in performance of any project company's obligation under the contract.[144] The counterparty usually will insist on the obligation of the project company or the lender on behalf of the project company to cover all the expenses for the provision of goods and services during the “step-in decision period”.[145]

One of the crucial clauses to include in the direct agreement deals with the statement of obligations. It refers to a written notice provided by the counterparty to the lender, listing all the non-extinguished liabilities of the project company to the counterparty. The statement of obligations should list all amounts due and remained unpaid at the date of the statement. It also includes monetary claims which will become due and payable to the counterparty prior to the lapse of the step-in decision period. This statement is of the significance for the step-in process of the lender. Usually, it is contractually stipulated that the liability of the additional obligor or substitute assigned by the lender will be restricted to those included in the statement of obligations. They shall have no liability towards the counterparty in respect of any claims

[143] ibid.
[144] ibid.
[145] Graham D Vinter, *Project Finance: A Legal Guide* (2nd edn, Sweet & Maxwell 1998) 165.

arising prior to the step-in date which were known by the counterparty and were not disclosed.[146]

4.4 Obstacles to enforcement of the direct agreement

Direct agreements originate from the Anglo-American legal family. Therefore, enforcement of certain provisions stipulated in this contractual arrangement can encounter resistance from the side of laws of jurisdictions which are civil legal systems.

One of the possible obstacles are insolvency laws that are less favorable to creditors than those in common law jurisdictions. Usually, in a direct agreement, a provision regarding the transfer of contractual rights to the lender or the entity appointed by the lender upon the insolvency of the project company may be found. For instance, this can clash with French insolvency rules, including: 1) automatic stay of enforcement actions by creditors against the debtor; 2) the exclusive power vested in the insolvency administrator to manage the company's affairs during insolvency proceedings; 3) prohibition of terminating contracts entered into by the insolvent company before the initiation of insolvency proceedings.[147]

Another issue may arise out of competition law provisions. If the original party to the contract cannot fulfill its duties, the lenders might step in and transfer those duties to the appointed entity. However, the problem can be faced when the original party was granted the possibility to obtain the contract under tender process in the framework of public procurement.[148] In such

[146] The analysis of the confidential Direct Agreement related to the Virtual Power Purchase Agreement entered into by the borrowers, the lender, and the buyer. The Direct Agreement relied upon is utilized and tested in practice for renewable energy project financing.
[147] John Dewar, *International Project Finance: Law and Practice* (Oxford University Press 2011) 378-379.
[148] Project Finance and Development Committee, 'Model Consent to Assignment for Project Finance Transactions (with Commentary)' (2012), 67 4 The Business Lawyer, 1193, 1195.

a situation, the appointed entity may be required to follow competition and procurement rules.[149]

4.5 Direct agreement in the context of public-private partnership

In this thesis, it is crucial to delve into the concept of the lender's step-in rights, not only in private project finance transactions but also in those involving a public party. Given the magnitude of these projects and their financial intricacies, such involvement is not uncommon and holds significant implications for their ability of the lender to step-in effectively.

4.5.1 Importance of the step-in rights in the public-private partnership context

The concept of enabling private companies to fund public sector infrastructure projects leads to the formation of Public-Private Partnerships (PPPs).[150] In the U.S., a PPP is described as a contractual collaboration between a governmental body and a commercially-oriented private entity. This partnership entails the sharing of resources and risks with the aim of delivering public services or advancing the development of public infrastructure.[151] Two main PPP models can be distinguished: "Concessions" and the "PFI Model."[152] In the Concessions model, the private entity's revenue comes from users' payments for the infrastructure provided, such as tolls and fares.[153] In contrast, the PFI Model[154] relies on payments from the contracting authority, as the projects developed, such as hospitals, public housing, or sewage systems, do not generate direct profit and are often subsidized by the government.[155] The PPP approach is widely utilized due to its significant advantages for the government, particularly its ability to

[149] John Dewar, *International Project Finance: Law and Practice* (Oxford University Press 2011) 380.
[150] A. Akintoye, M. Beck, C. Hardcastle (Eds.), *Public–Private Partnerships: Managing Risks and Opportunities*, (Blackwell Science Ltd. 2003) 4.
[151] ibid, 16.
[152] E. R. Yescombe, *Principles of Project Finance* (2nd edn, Academic Press 2014) 16.
[153] ibid.
[154] the term originates from the Private Finance Initiative (PFI) program, which was adopted by the UK government in 1992 and subsequently gained popularity worldwide.
[155] E. R. Yescombe, Principles of Project Finance (2nd edn, Academic Press 2014) 16.

economize resources, including financial ones.[156] As can be seen from the above, the notion of PPP is used broadly and does not necessarily equate to the notion of project finance.[157] Project finance is one form of financing commonly utilized in the context of PPP projects, alongside others such as equity investments or non-recourse forfeiting of instalments, etc.[158]

It can be argued that a PPP relies on shifting the majority of risks from the public sector to the private sector, retaining only those risks that the client, namely government representator, can effectively manage.[159] This leaves the lender in a risky financial situation, wherein the loan may not be repaid for the reasons already discussed above.

These risks can be mitigated by several techniques. For instance, it can be transferred to public sector by means of government guarantees to the lender in respect of contractor liabilities.[160] Another solution is to include "material adverse event" clauses into the concession agreement, potentially extending the concession period.[161] Letter of comfort may be provided to the lender by the representator of the public sector.[162]

However, these safeguards are not sufficient enough and the risks of the non-repayment is still high. Moreover, these techniques are not widespread; the PPP typically stands on the ground that the state should not guarantee loans provided by private parties.[163] Furthermore, the termination of the project by the contracting authority itself is of significant concern for the

156 LiYaning Tang, Qiping Shen, Eddie W.L. Cheng, 'A review of studies on Public–Private Partnership projects in the construction industry' (2010), 28 7 International Journal of Project Management 683.
157 E. R. Yescombe, *Principles of Project Finance* (2nd edn, Academic Press 2014) 17.
158 Dirk Daube and Susann Vollrath, 'A comparison of Project Finance and the Forfeiting Model as financing forms for PPP projects in Germany' (2008), 26 4 International Journal of Project Management 376.
159 A. Akintoye, E. Chinyio, 'Private finance initiative in the healthcare sector: trends and risk assessment' (2005) 12 6 Engineering, Construction and Architectural Management 601.
160 A.B. Alonso-Conde, C. Brown, J. Rojo-Suarez, 'Public private partnerships: incentives, risk transfer and real options' (2007) 16 4 Review of Financial Economics 335.
161 C. Brown, 'Financing transport infrastructure: for whom the road tolls' (2005), 38 4 The Australian Economic Review 431.
162 D. Asenova, J. Hood, 'PFI and the implications of introducing new long-term actors into public service delivery' (2006) 21 4 Public Policy and Administration 23.
163 ibid.

lender. This is because even in cases where a termination payment is offered by the contracting authority, it may not suffice to cover the entire debt amount. Therefore, lenders are motivated to restore the PPP contract's momentum to ensure scheduled and complete debt repayment.[164] Hence, the lender's ability to intervene in the project through exercising step-in rights gains even more importance.

4.5.2 Authorisation of direct agreement by national legislation

The availability of a legal framework that allows the lender to exercise their step-in rights is crucial in the context of public-private partnerships. In certain countries, the implementation of such clauses may be impeded due to a lack of relevant laws.[165] Effective PPP legislation usually grants the contracting authority authorization to enter into both PPP contracts and their typically accompanying direct agreements.[166] Otherwise, there is a risk that mandatory provisions covered by public policy rules, such as bankruptcy laws and public procurement regulations, may pose obstacles to the effective utilization of direct agreements by both the contracting authority and the lender.[167]

4.5.3 Concession agreement as a substitute for direct agreement

Sometimes it is difficult for the lender to negotiate direct agreement with the government for various reasons in such a case, step-in rights may be stipulated in concession agreement.[168] A concession agreement entails a contractual arrangement between a governmental entity and a

[164] 'Guidance on PPP Contractual Provisions' (International Bank for Reconstruction and Development/The World Bank, 2019) <https://consultations.worldbank.org/en/consultations/detail/guidance-ppp-contractual-provisions> accessed 25.03.2024.
[165] 'Legislative Guide on Privately Financed Infrastructure Projects' (UNCITRAL, 2001).
[166] 'Guidance on PPP Contractual Provisions' (International Bank for Reconstruction and Development/The World Bank 2019) <https://consultations.worldbank.org/en/consultations/detail/guidance-ppp-contractual-provisions> accessed 25.03.2024.
[167] ibid.
[168] Christopher Clement-Davies, 'Public/Private Partnerships in Central and Eastern Europe: Structuring the Concession Agreement' (2001) 1 Bus L Int'l 17.

private firm (referred to as the "concessionaire"), whereby the government grants the company the authority to operate, manufacture, or deliver a good or service within the nation for a specified duration, while retaining ultimate ownership of the right.[169] The direct agreement is considered the most reliable mechanism for stipulating step-in rights.[170] However, project finance history includes successful instances of incorporating the right to intervene solely through the concession agreement.[171] This was achieved through the creation of a security package, as demonstrated in the Second Stage Bangkok Expressway project in Thailand.[172] Nonetheless, for this to be feasible, local law must permit the creation of enforceable third-party rights through contracts to which the third parties themselves are not signatories.[173]

4.5.4 Form of the direct agreement

Despite the ability to stipulate step-in rights in concession agreements, direct agreements remain the most utilized instruments in the context of public-private partnerships. Typically, the direct agreement is executed concurrently with the PPP Contract or concession contract.[174] However, in specific instances, it may be signed later, usually at financial close (as observed in the Netherlands or the United States).[175] In such scenarios, the direct agreement is essentially finalized at the time of signing the PPP Contract, with the agreed-upon form appended as an exhibit.[176] Certain jurisdictions have implemented uniform provisions that must be adhered to by both contracting authorities and financial institutions. Examples of these standardized

[169] see Nicholas Miranda, 'Concession Agreements: From Private Contract to Public Policy' (2007) 117 Yale LJ 510.
[170] Christopher Clement-Davies, 'Public/Private Partnerships in Central and Eastern Europe: Structuring the Concession Agreement' (2001) 1 Bus L Int'l 17.
[171] ibid.
[172] ibid.
[173] ibid.
[174] ibid.
[175] ibid.
[176] ibid.

guidelines include the South Africa PPP Guidelines, the Dutch Model, and the UK PF2 Guidance.[177]

The Standardization of PF2 Contracts guide, published by the UK HM Treasury in 2012, can be regarded as one of the best practices introduced for the model direct agreement.[178] While no longer employed in the United Kingdom since 2018, except for preexisting projects, it remains globally recognized and extensively utilized.[179] In numerous European countries, non-concession direct agreements often draw from the recommendations and model form outlined in the document, albeit with variations reflecting aspects of applicable law and the commercial specifics of individual projects.[180]

4.6 Utility of the direct agreement

The efficacy or usefulness of a direct agreement may be questionable. Especially when step-in rights are exercised in the extreme form, namely the removal of the project company from running the project.

The harm to the project itself is highly probable. Firstly, such a scenario may delay the terms of project implementation. In order to fully substitute the previously in-charge company, time is necessary to transfer the knowledge base, contractual documents, and train top management. Secondly, the quality of project realization may suffer. This can be explained by the practical challenge that arises when a newly responsible company, in the midst of project completion,

[177] 'Guidance on PPP Contractual Provisions' (International Bank for Reconstruction and Development/The World Bank 2019) <https://consultations.worldbank.org/en/consultations/detail/guidance-ppp-contractual-provisions> accessed 25.03.2024.
[178] Alexei Zverev ed, EBRD PPP Regulatory Guidelines Collection (vol I, ch 11, European Bank for Reconstruction and Development 2024) 3.
[179] Alexei Zverev ed, EBRD PPP Regulatory Guidelines Collection (vol I, ch 11, European Bank for Reconstruction and Development 2024) 3.
[180] ibid.

finds it nearly unrealistic to identify all the nuances and potential problems that may emerge during implementation.

The project company evidently has little interest in exercising step-in provisions of direct agreement. This is because direct agreement effectively excludes the project company from the equation once it defaults, establishing a direct relationship between the lenders and the project contract counterparts.[181]

The practical implications of the exercise of step-in rights is also questionable for the lender.[182] Particularly when a direct agreement mandates the lender's interference in the project without appointing another company with sector knowledge. The potential drawbacks, such as additional costs and unpredictable outcomes, are significant concerns.

However, despite all the deficiencies, it should not be overlooked that direct agreements are typically designed to benefit the lender. From its perspective, the crucial aspect lies in the fact that the real value of their security resides in the project contracts. Direct agreements enable swift intervention in the event of a default by the project company, allowing the lender to protect these contracts and find another party to assume them.[183] Provided that a security package is not sufficient for debt repayment, step-in rights remain one of the most effective tools for the lender to safeguard its financial interests.

[181] E. R. Yescombe, *Principles of Project Finance* (2nd edn, Academic Press 2014) 196.
[182] ibid.
[183] ibid.

CONCLUSION

The goal of the thesis was to examine the concept of step-in rights at a theoretical level, exploring different aspects relevant to their exercise. Firstly, an introduction to the peculiarities of project finance transactions was provided, emphasizing its main characteristic: servicing the loan primarily out of the cash flow generated by the completed project. Special attention was dedicated to the risks associated with project financing, which can influence the ability to repay the loan provided by the lender, and as a result, highlight the significance of stipulating the lender's step-in rights. The importance of step-in rights was underscored by key factors such as the uncertainty of the borrower's creditworthiness, the non-recourse nature of the loan, and the presence of external risks beyond the lender's control.

Upon justifying the existence of step-in rights, the thesis offered an explanation of the concept itself and identified levels of its exercise, which typically correlate with the degree of intrusion into the project management allowed to the lender. The first level, known as cure rights, entails the lender's ability to fulfill certain borrower obligations (representing the narrowest intervention). The second level, referred to as step-in rights in the strict sense, implies the lender's ability to intervene alongside the project company after a breach has occurred. The third level, novation, involves the complete change of project management by replacing the project company.

The thesis examined various tools for exercising step-in rights, noting their limited availability, which depends on local laws specific to jurisdictions. Step-in through the corporate governance structure provides the lender with the ability to either directly influence the decision-making process of the project company by exercising assigned voting rights or indirectly restrict the decision-making power of the entity through veto rights or by appointing directors to the board representing their interests. Another possibility for step-in may be available through enforcing the pledge on the shares of the project company. However, the ability to vote on the shares enforced may be limited by local law requirements, such as the prohibition of lex commissoria. In contrast, the transfer of shares by means of a call option to the lender is treated as a purely contractual arrangement, which is considered to be its biggest advantage, notwithstanding the laws applicable to regulate this type of contracts. A notable solution providing the mechanism to step-in is available under English law, which allows for the out-of-court appointment of a receiver through the enforcement of a floating charge. Importantly, the receiver primarily owes obligations to the creditor with the security interest and therefore the floating charge is deemed to be an effective tool for the lender to step-in.

Further, the thesis explored the nature of the direct agreement – a contractual arrangement between the lender, the project company, and the counterparty to the assigned commercial contract, which contains provisions governing the step-in process. Crucial clauses incorporated into the agreement are highlighted, with emphasis also placed on the obstacles to enforcing the direct agreement in certain jurisdictions, such as provisions of competition and public procurement laws.

The direct agreement is not only described in isolation but is also contextualized within the framework of public-private partnerships. The necessity of effective PPP legislation is evidenced for the opportunity to exercise step-in rights, with particular attention drawn to the process of signing agreements with the contracting authority.

The thesis concluded with an assessment of the utility of the direct agreement for the lender. The step-in rights incorporated into it are not always beneficial for the lender to exercise due to the fact that financial institutions usually lack industry-specific knowledge to continue managing the project. However, it must be acknowledged that considering the absence of other instruments available to the lender through which it can secure repayment of the debt, step-in rights could contribute to achieving this task, despite the burdens associated with their implementation.

The examination of various issues associated with the lender's step-in rights, as presented in this thesis, reveals a complex interplay between regulatory frameworks and contractual creativity available to the parties involved. Despite the lack of specific procedural guidelines by national legislators, limitations persist that can hinder lenders from safeguarding project completion through direct participation. These limitations often stem from corporate and commercial law norms, which to some extent restrict the contractual creativity of the parties or the effectiveness of certain legal tools through which step-in rights can be exercised. For instance, under Lithuanian law, a pledgee cannot vote on pledged assets in the event of default. Similarly, various state laws in the US require the transfer of shares into the name of the pledgee to entitle them to voting rights, thereby limiting the lender's ability to step in effectively. Therefore, given the typically international nature of project finance, careful consideration must be given to market practices and regulatory frameworks in each specific jurisdiction to determine the most effective tools for exercising step-in rights.

Another significant aspect is the exercise of step-in rights within the context of public-private partnerships. Here, attention must be paid not only to the interests of the lender as the financing party but also to the often-competing interests of the contracting authority, which ultimately becomes the final beneficiary of the implemented project. While concession laws generally grant lenders the right to step in, these laws often lack detailed provisions, leaving many issues unresolved. The stronger position of state agencies compared to foreign private lenders can create certain risks for financiers, influenced not only by existing regulations—which may not favor lenders—but also by the independence of the judicial system and the availability of remedies. In light of the above, there is significant scope for further research into the examination of best regulatory practices across various jurisdictions. Such research should aim to establish additional protections for lenders by creating a robust regulatory framework with detailed procedures, thereby enabling lenders to effectively exercise their step-in rights within the context of public-private partnerships.

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