



Partnership

ARTHUR COX

EXPECT EXCELLENCE

JANUARY 2010

‘Boasting the largest project finance team in Ireland...’

IFLR 1000: The Guide to the World’s Leading Financial Law Firms, 2010

‘Arthur Cox remains in the top tier this year following strong recommendations from clients, who note the firm’s ability to act for sponsors of PPP transactions.’

IFLR 1000: The Guide to the World’s Leading Financial Law Firms, 2009

‘“They’re excellent, just great,” says one. “I’d say they were the all-round best firm ... and especially adept at project finance.”’

IFLR 1000: The Guide to the World’s Leading Financial Law Firms, 2009

‘Arthur Cox’s project finance team is described by one client as “very good, very professional and know their stuff.” The firm’s lawyers came in for praise from all corners of the market.’

IFLR 1000: The Guide to the World’s Leading Financial Law Firms, 2008

This document contains a general summary of developments and is not a complete or definitive statement of the law. Specific legal advice should be obtained where appropriate.

Project Finance Brief

Project Funding: a return to more rigorous constraints?

The credit crunch continues to disrupt all sectors of the economy - and the construction industry in particular. Construction companies are facing major challenges: increased competition, a slowdown in activity, decreasing property prices and difficulty in raising finance. Where does lending go from here?

As a reflection of the current lack of liquidity in the lending market and the perceived increased risk of borrower insolvency, banks are invariably tightening their lending procedures and are much more likely to ensure that *all* pre-lending criteria have been adhered to prior to allowing *any* drawdown of the relevant funds. The demand for rigorous credit control by the lending institutions has consequently led to less flexibility on the waiving of particular terms on individual deals than may have been experienced before.

The tightening of available credit lines to financial institutions themselves on the international markets has, amongst other factors, had an inevitable impact. Moreover, it has had serious consequences for projects which had failed to secure funding prior to the current liquidity difficulties.

Even where banks are ostensibly available and willing to provide loans to developers, funding terms have changed radically. Although some commentators have argued that they may have peaked, margins and arrangement fees have inevitably increased as banks pass on the increased costs of making funds available.

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More recently, the importance of proper legal and technical due diligence has become apparent; this includes the reviewing of building and other contract terms, the

examination and obtaining of fully executed collateral warranties *prior to drawdown* and negotiating specific financial covenants. These issues are examined in brief below.

Due Diligence

When considering whether or not to fund a particular project, banks will undertake a due diligence of the financial soundness of both the project itself and the key project parties. As part of this examination, banks will require evidence of financial standing of the main sponsor(s) and, depending on the size or nature of the project, possibly even sub-contractors undertaking key works packages. The construction budget and cash flow forecast for the project will be scrutinised and developers will increasingly be expected to justify any forecasts where concerns are raised by the bank. Cost overruns associated with any project are as much a concern for the lending institution as for the developer/sponsors.



Building Contract Terms

The risk allocation under the suite of building contracts is of obvious significance for the funders and sponsors and *will be closely examined*. Any contractual risk assumed by the developer can ultimately be regarded as a risk for its funding bank, to the extent not assumed or adequately passed down. As part of their general review, the funder's solicitors will be asked to review and comment on the terms of the relevant building contracts, focussing on unusual or unduly onerous terms. In this regard, developers would be well advised to meet with their prospective funders sufficiently in advance of finalising contracts to ascertain the funder's particular requirements. This will facilitate the negotiation of the building contract with these in mind. Fore-warned is fore-armed!

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Collateral Warranties

The provision of collateral warranties by sub-contractors carrying out key sub-contract packages is commonplace, particularly in respect of those sub-contractors with design responsibility. Collateral warranties are agreements whereby a sub-contractor warrants to a third party that it has complied with the terms of its sub-contract. Collateral warranties generally also provide a funder with the right to step into the shoes of the developer in the event of developer default.

Developers will be expected to provide a full suite of collateral warranties to the bank. Save where relevant appointments are to follow financial close, having these warranties in place will form part of the pre-drawdown criteria. Again, developers would be advised to bear the bank's particular requirements in mind when negotiating the terms of warranties to avoid potential difficulties.

Conditions Precedent / Security Package

Conditions precedent are clauses in a loan agreement that provide that the agreement, or certain obligations under the agreement, will only come into force if and when specified conditions are met. If a loan agreement is expressed to be subject to a particular condition precedent, no binding contract will exist until that condition has been satisfied. If only certain specified obligations under the agreement are expressed to be subject to a condition precedent, a contract exists, but the relevant obligations only take effect when the condition is fulfilled.

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Conditions precedent to the approval of a developer's finance package typically include the provision of a comprehensive security package to the bank. This can include: (1) a floating charge over assets of the developer and/or the project concerned; (2) a standard security over the development site (e.g. a mortgage); (3) third party

guarantees of the obligations of the developer, including a cost overrun guarantee and an interest shortfall guarantee, provided by either a company in the same group as the developer, a director of the developer personally or another financial institution (additional costs may arise for the developer) (4) the assignment of the building contract, performance bond or other guarantee issued in favour of the borrower by the contractor.

Financial Covenants

Banks generally seek to impose various financial covenants on developers when providing funding. A covenant (or undertaking) is simply a promise made by the borrower to do or to refrain from doing something. Financial covenants are primarily concerned with ensuring the project performs

within stipulated parameters whether by reference to cash flow, ability to service debt repayments on the length of the loan.

Financial covenants in loans should be approached with caution by developers for two reasons. Firstly, constraints and burdens may have an impact on their day-to-day business. Secondly, a breach of covenant will possibly lead to an event of default resulting in an acceleration of the loan and the enforcement of security.

Generally speaking, however, financial covenants are intended to protect the bank and the developer. Financial covenants are often the bank's first warning of a problem and have become particularly important as a protection against developer insolvency, allowing steps to be taken as soon as a developer's financial difficulties are known.

What these changes mean to you

Whilst obtaining finance for construction projects has unquestionably become more difficult in the current climate, given recent support for certain PPP projects there are reasons to be optimistic for future (well structured) transactions. However, it is clear that securing finance will require strict adherence to risk assessment and due diligence by funders. Funders will be unlikely to deviate from any of these criteria before making a loan available. All of this gives rise to the following position:

- » increased levels of due diligence and monitoring criteria prior to drawdown of funds;
- » a wider general focus on 'credit issues';
- » longer and more detailed internal credit approval processes; and
- » potential impact on higher costs.

However, there is always scope for negotiation and sensible deal structuring to negate these factors. As Arthur Cox has extensive and very recent experience in assisting with project finance and construction funding in a tight, post credit-crunch market, we are ideally placed to help you in this respect.

Contacts

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