How to Overcome Limitations to Lenders' Step-in Rights Under Mexican PPAs

By **GABRIELA PÉREZ SIERRA**

On September, 2017, Abengoa announced the agreement to sell the 907 MW combined cycle project called Norte III, in the state of Chihuahua (México), to be developed and operated pursuant to a power purchase agreement entered into with the Mexican Federal energy commission (*Comisión Federal de Electricidad*, "**CFE**").[1] This project had received financing through an Abengoa Mexican special purpose vehicle before Abengoa's pre-insolvency filing in Spain in November of 2015.[2] As a result of this filing, lenders' step-in rights under the power purchase agreement in an event of insolvency became very relevant and were extensively analyzed by Mexican legal advisors. The terms of those step-in rights are significantly similar to the ones in the current form long term power purchase agreements ("**LT-PPA**") for the first, second and third-round power bids organized by the Mexican National energy control center (*Centro Nacional de Control de Energía*, "**CENACE**") under the current Mexican law to regulate the electric energy industry (*Ley de la Industria Eléctrica*).[3] Considering the Norte III experience, the step-in rights for lenders under the LT-PPA might be limited when attempting to foreclose on the collateral created for a project finance in the event of the sponsor's insolvency.

Lenders' Step-in Rights under the LT-PPA

The purchaser under the LT-PPA may terminate the agreement upon occurrence of one of the events of default of the seller listed in the LT-PPA. Notwithstanding, before the purchaser terminates the LT-PPA, it should notify the seller and its lenders of its intention to do so.[4] After receiving the purchaser's notice, the project lenders may notify the purchaser of their intention to (i) remedy the event of default or (ii) enforce their control or step-in rights over the seller and foreclose on their collateral, or both.

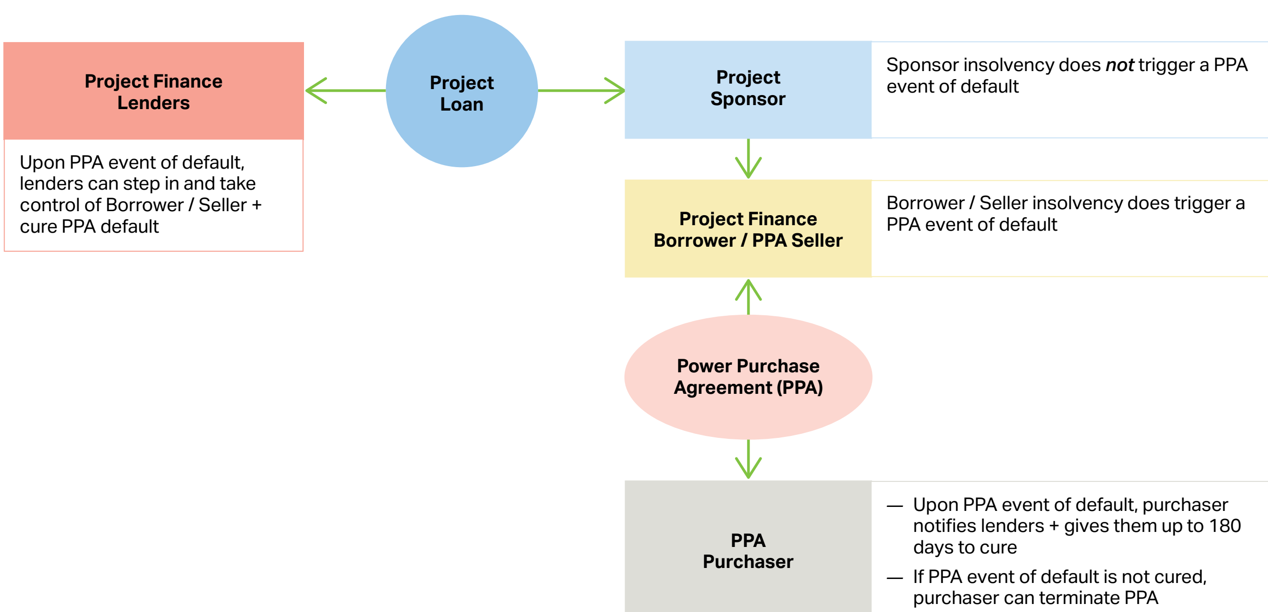
Following the notice by the project lenders to the purchaser, the purchaser shall refrain from terminating the PPA agreement for up to180 days. During such time, lenders can remedy the seller's event of default by enforcing their collateral to take control of the seller and consequently of the project.

Practical and Legal Limitations to Step-in Rights

Under the LT-PPA, the step-in rights of a lender are triggered if an event of default of the seller under the LT-PPA occurs. Note that the LT-PPA does not provide for a cross-default of such agreement if there is an event of default by the seller under the loan by which project is financed. Therefore, there could be a scenario where the project loan is in default but the LT-PPA is in full compliance.

However, under the LT-PPA, the seller's insolvency (*concurso mercantil*) or its bankruptcy (*quiebra*), or the seller's acceptance of a receiver constitute events of default. On the other hand, if the seller's sponsor becomes insolvent or bankrupt, or acknowledges its inability to pay debt such circumstances are not an event of default under the LT-PPA, although they may be an event of default under the project financing loan agreement.

Mexican PPAs – Project Lenders Step In Rights



Events of Default under Project Loan v. PPA		
Events of Default	**Project Finance Credit Agreement**	**Power Purchase Agreement**
Event of Default of Borrower under Credit Agreement	— Event of default → lenders can enforce remedies	— No cross-default → lenders do not have step in rights
Event of Default of Seller under PPA	— Cross-default → lenders can enforce remedies	— Event of default → lenders have step in rights
Event of Default of Seller under PPA	— Cross-default → lenders can enforce remedies	— Event of default → lenders have step in rights
Insolvency of Borrower / Seller	— Event of default → lenders can enforce remedies	— Event of default → lenders have step in rights
Insolvency of Sponsor	— Event of default → lenders can enforce remedies (but no PPA step in rights)	— No event of default → lenders do not have step in rights

Strictly speaking, if the loan is for a project finance there is a presumption that the project and the lender are bankruptcy remote vehicles and, therefore, the sponsor's financial condition should be less relevant. However, to the extent that the sponsor is required to contribute any equity during the term of the loan and the project is under construction, as is the case in many projects in Mexico, the sponsor's solvency becomes more relevant.

Should the sponsor become insolvent or if it acknowledges its inability to pay its debts, there is a risk that it will be unable to make its equity contributions, which could possibly delay the project. Furthermore, while any insolvency procedure is pending, the lenders' remedies against the sponsor could be limited. Consequently, in such case it would be reasonable for lenders to notify of the occurrence of an event of default under the project finance loan agreement and foreclose on the project by selling it to a reasonable third party that can guarantee the construction and operation of the project as scheduled.

Therein lies the problem, in the event of the sponsor's insolvency, there would be an event of default under a project finance loan agreement and the lenders could seek to foreclose on the collateral; however, they would not have step-in rights under the LT-PPA because the sponsor's insolvency does not trigger an event of default of the seller under the LT-PPA.

The above does not mean that the lenders cannot seek to foreclose, but there are a number of issues stemming from the fact that lenders do not have a direct relationship with the purchaser under the LT-PPA.

For any sale of the project to occur, the LT-PPA requires the seller to request that the purchaser authorize a change of control (and the purchaser to agree). Note that the seller is the only party authorized to make such a request under the LT-PPA (except when lenders enforce their step-in rights). If lenders cannot exercise their step-in rights under the LT-PPA, they could obtain corporate control over the seller/borrower and then proceed to request that the purchaser authorize the change of control.

The lenders could obtain such control over the seller/borrower by means of a Mexican guarantee trust (*fideicomiso de garantia*) created pursuant to a trust agreement. Under this construct, all but one of the shares representing the capital stock of the borrower are contributed to the trust, and, upon an event of default notified to the borrower, the trustee, through the instructions of the administrative agent as beneficiary under the guarantee trust, could enforce the voting rights under each share contributed to the trust and take control of the borrower on behalf of the lenders.

Once lenders have corporate control over the seller, they should be able to request the change of control to sell the project to a third party as part of their collateral enforcement rights. In practice, however, this extra hurdle can mean that the foreclosure process would take longer and become more cumbersome.

Strategies to Address Limitations to Lenders' Step-in Rights

The analysis in this article addresses the worst case scenario in which there is a LT-PPA entered into by a seller, and the seller, in turn, has a sponsor not party to the LT-PPA that could have liquidity constraints at some point during construction of the project, which could affect its ability to fulfill its equity contribution obligations in a project finance and in which there are no viable alternatives to fund such equity, like sufficient reserve accounts or a letter of credit and, furthermore, that those constraints lead to insolvency or the declaration of the inability to pay debt.

In these specific cases, lenders have alternatives to prevent limitations to their step-in rights under the LT-PPA; however, none of them are addressed as specific prerogatives under the LT-PPA and they should all be negotiated with the purchaser.

The most straight forward approach would be to amend the LT-PPA to include the sponsor's insolvency as an event of default under the LT-PPA. There might be a discussion however, as to how much the agreement can be amended given that it is a form and it is entered into as a consequence of a public bid.

Alternatively, lenders could seek to mitigate the limitation to their step-in rights discussed here through the direct agreement with the purchaser under the LT-PPA, to clarify that the sellers' insolvency should also include the insolvency of its sponsor.

In any case, based on the above, the LT-PPA does not fully address the risk of lenders associated with the solvency of the sponsor, particularly during the construction period of a project, and there could be limitations to step-in rights; Notwithstanding, as mentioned herein, it is possible to foreclose on the lenders' collateral with the current provision of the LT-PPA, it might just take a bit longer than it should. ■

1. http://www.abengoa.com/export/sites/abengoa_corp/resources/pdf/noticias_y_publicaciones/20170901_NP_NIII_Final_ING.pdf
2. http://www.abengoa.com/export/sites/abengoa_corp/resources/pdf/gobierno_corporativo/hr_y_otras_comunicaciones_cnmv/hechos_relevantes/2015/20151127_hr_en.pdf
3. The LT-PPA for each bid are available at http://www.cenace.gob.mx/Paginas/Publicas/MercadoOperacion/SubastasLP.aspx
4. Under the LT-PPA, a lender is any entity that grants financing to the seller under financing documents (including agents, trustees and representatives) provided that their name, contact information and financing amount are notified to the purchaser.

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Ms. Pérez Sierra has over eleven years of experience advising national and foreign clients in various transactions in Mexico and abroad. She has represented Mexican and foreign banks and multilaterals, including CAF, SMBC, Caixa Bank. She has also represented sponsors and borrowers in several types of transactions, including project finance, granting of partial credit guarantees and equity and bond issuances in the capital markets. Additionally, she has advised foreign and domestic investors in M&A transactions.

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