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International Project Finance

Harold F. Moore* and Evelyn D. Giaccio**

I. Introduction

International project finance involves many types of credit support. Successful project financing brings together the most useful equity and debt components available which enable the project to generate cash flow, tax benefits and host or supplier country credits. This article discusses the relevance of credit controls, sovereign defaults, political risk and exchange risks, as well as the usefulness of devices such as government assisted trade finance or insurance, counter trade, currency swaps, interest rate swaps and several new types of debt instruments and facilities that have been added to the international bond market. A general definition of project financing is presented first with an overview of the risks involved and risk minimalization techniques. Various documentation issues outline the legal framework involved in any project financing, and help focus specifically on considerations particular to international projects.

Several recent developments in U.S. project financing illustrate generic legal issues. The developments reviewed in this article include: 1) the validity of contracts containing “take-or-pay” provisions and the contractual defenses applicable to such contracts, and 2) the concept of “force majeure.” When transactions are international in scope and sovereign credit may be involved and itself create force majeure, the latter issue becomes more important.

II. Elements of Project Financing

A. Definition of Project Financing

Much confusion stems from the various uses of the term “project financing.” This article uses the term in its historical context to refer to financing of the construction or development of a project where the lenders rely primarily on the expected cash flow generated by the operation of the project for repayment of their loans as well as

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for the value of the project's assets.1 The term includes more than mere lending to a project if the loan is made directly on the credit of the sponsoring entities. While the credit of the sponsors may be indirectly involved either in the supply of raw material to the project or in the consumption of the product or project, the financing is not a direct obligation of the sponsors and does not appear as a direct loan obligation on the liability side of the sponsor's balance sheet.

A separate project entity, such as a partnership, joint venture or special purpose corporation usually is formed for the sole purpose of owning and operating the project. To finance the project, the lender makes loans to this newly created entity. The loans are non-recourse to the project's sponsors. Non-recourse loans are required because projects involve parties from more than one legal system and often require additional credit support from guarantees and contractual undertakings of sponsors and other interested third parties. Third party project participants include purchasers or suppliers of the project's output and services, lessees of the project, and the host government or export credit agencies of countries whose products are used to construct or operate the project. Under the contract with the project company, these entities provide funds for servicing project debts, or guarantees of debt, or insurance for financing other aspects of the project. Lenders rely on these third party contracts to mitigate the commercial and political risks inherent in project financing.

B. Risk Identification

The lender's most critical concern at the outset of a proposed international project financing is the identification of all sources of risks. Many are similar or merely an expanded formulation of risks found in a domestic project financing. The life of a project can be divided into two phases: the construction phase and the operating phase. During the construction phase, the principal risk is whether the project will be completed and if it is completed, whether it will be completed on time and at an acceptable cost.2 Following completion, operating risks arise, such as whether the project works as designed, whether it is efficient, and whether the costs of the raw materials and the price and size of the market for output meet with the initial projections. Throughout both phases, tax and regulatory issues in the jurisdictions of both the project and the sponsors affect the project.

Political risks in international financing are more acute than in

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domestic project financing, and the choice of law applicable to all aspects of the project is international in scope. Throughout the life of the project, the relationship of the currencies of the sponsors and the project adds to the international risk. The risks of each phase differ and must be identified and allocated among the participants at the outset. Documentation difficulties in allocation of risk arise when the debt interests seek to allocate risk to equity participants while maintaining unfettered rights to the collateral.

1. **Construction Phase**

Prior to lender involvement, permits are required to conduct and to secure government project feasibility studies. Feasibility risk assessment anticipates for the lifespan of the project the availability and cost of raw materials, and the market for project output at reasonable prices. Changes in laws governing the project constitute substantial political risks, making the host government's attitude toward the project a critical consideration. If the government is interested in the development of the project because it creates jobs or supports other national interests, permits may be quickly secured and risks are minimal. Indeed, the host government may actively promote the project. At a minimum, the benign neglect of the host government should be assured before spending heavily during construction.

Once a project is deemed technologically and economically feasible and the host government's interest or cooperation with the sponsors is assured, the host government issues a mandate or the sponsors seek financing appropriate to the construction and operation of the project. The form of financing is matched to the different risks involved in each phase.

The lender's risks in the construction phase are linked with the political and technological risks of the project. In the construction phase lenders have no cash flow upon which to rely for repayment. Lenders are at maximum risk for loss of principal and interest if the project is not completed, is delayed, or if costs are substantially increased due to regulatory requirement changes. In the construction phase, a change in governments with a concomitant change in attitude toward the project can be just as troublesome as civil disturbance or war. A new government can use import or export restrictions, exchange controls, or labor and tax laws to interfere with construction and timely completion of the project within budget.

The technological risk that the project, though completed on time and within budget, does not start or cannot achieve design capacity, may create a credit bind. Construction loans are typically short term, concluding at the start of commercial operations. As the
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project successfully passes start-up procedures, construction lenders expect repayment from permanent financing provided by project sponsors or interested third parties.

2. Operational Phase

Once the project passes the construction stage, the major risk becomes the ability of the project cash flow to service the debt. The operational phase is considerably longer than the construction phase, making economic risks greater. The accuracy of the economic and technological feasibility study is vital. Adequate raw materials must be available within projected cost, customers for the output must be prepared to purchase projected amounts at projected prices, and capable management must be present in the host country. Accurate projections of currency and foreign exchange relationships between the host country currency, the loan currency, and the sponsor country are similarly significant.

Expropriation and civil disturbance are obvious political risks. More insidious risks are creeping expropriation through taxation, regulation of ownership or management, import or export restrictions on raw materials or finished goods, and the ability to enforce security interests in the physical assets of the plant, raw materials, and finished goods.

If the above risks are properly allocated between the debt and the equity interests, the debt must be financially engineered to match the cash flow stream. Various combinations of accrual notes which change to interest payments, graduated payment loans, and other devices help to accomplish these goals.

III. Mitigation of Risks; Limitations

A. Pre-Completion

Prior to the completion of a project, when all components exist for providing credit support to service the debt, the project contracts provide the lender with various rights and remedies. Typically these rights include recourse and access to a creditworthy entity. The pre-completion obligations of the sponsor typically assure the lenders that: (a) the project will be completed by a certain date (within agreed on mechanical, operating and financial parameters), (b) all cost overruns and other incidental matters will be funded in a timely fashion and on acceptable terms, and (c) the sponsors can obtain all funding necessary to service the debt until the project is completed.3

3 "Completion" should be defined comprehensively for each project. The definition should include reasonably objective means for identifying any circumstance necessary for the project to operate at pre-determined economic levels in compliance with applicable laws and regulations.
The sponsor's undertaking of project completion can be secured in various ways. If off-balance sheet financing is not required, the lender may consider a direct guarantee of the pre-completion debt. If a direct guarantee cannot be used, indirect credit support in the form of required equity contributions or fully subordinated debt may suffice. An unconditional obligation of the sponsor to purchase the debt instruments offers equivalent protection if project completion is not achieved.

In addition to the foregoing general concerns, international projects must contend with exchange and political risks. During construction, the risk of foreign exchange losses usually is borne by the sponsors who provide additional funding. However, lenders may assume some of the exchange risk "through multi-currency loans which give borrowers an option, based on a fixed exchange rate, of repayment in different currencies."4 Ordinarily, a concession agreement with the central bank of the host country governs the ability of the project company to deal in local or foreign currencies.

A common concession agreement between the host government and foreign sponsors provides each party certain assurances regarding foreign currency remittances, import licenses, tax liability, foreign personnel, and the extent of equity participation by the host country.5 Project planners should be sensitive to the potential risks of host country involvement in the disposition of project output and in management's decision-making. In the case of petroleum and mining projects, the concession agreement should describe the rights of foreign sponsors to conduct exploration, development, production and marketing.6

In addition to the concession agreement, to minimize their exposure to political risk, lenders may request of the host country: (i) advance assurances that licenses and permits requiring the sanction of an agency of the host country will be granted,7 (ii) any necessary governmental approvals of long-term sales contracts, assignment of the proceeds of such contracts, and registration of debt, (iii) a "non-interference" agreement that the host country will not interfere with the operation of the project or repayment of the debt, and (iv) political risk insurance against expropriation.

Political risks can be lessened further by "multi-nationalizing" the sources of finance for the project. The involvement of lenders

6 See id. at 36.
7 See 2 P. NEVIT, PROJECT FINANCING 16 (4th ed. 1983); Rendell & Niehuss, supra note 5, at 33-37.
from different countries and the participation of official international institutions such as the World Bank and regional development banks minimizes the possibility of arbitrary political action by the host country.

Exchange risks can vitiate this political risk reduction technique if the currencies of the project's revenues are not closely matched with the currencies of the debt. An alternative method is to require the payment of debt service at a place and in a currency which circumvent the political and currency risks associated with the project. Irreducible political risks attend any project, and the willingness of a lender to accept such risks, thereby sharing and minimizing the risks of the project, may be the very reason the lender has been invited to participate in the financing.

B. Post-Completion

1. Enforceability

Typically, upon completion, the lenders only have recourse to the project and its revenues. To assure repayment of the obligation under all circumstances, the project's ability to generate revenues may be supported by a variety of credit or contract undertakings, such as the sponsor's obligation to purchase goods, to maintain working capital in a specific form and manner, or to repay the loan throughout production. Accordingly, the enforceability of such undertakings is of central importance in analyzing whether the project can support the credit granted. Recent U.S. cases indicate that "take-or-pay," "hell-or-high water" and similar unconditional contractual obligations, in a properly documented and structured project financing, are, generally, enforceable in U.S. courts. However, limitations on enforceability based on the procedural and substantive provisions of the Federal Bankruptcy Code (the "Code") should be reviewed carefully in any project. Moreover, in addition to ordinary contractual obligation defenses, three primary defenses have been pursued against unconditional project support obligations: force majeure, impossibility and regulatory defenses.

In *In re O.P.M. Leasing Services, Inc.* the U.S. Bankruptcy Court upheld a "hell-or-high water" clause in a contract under New York law. West Virginia leased computer equipment from O.P.M. under a master lease, whereby West Virginia had an "absolutely unconditional" obligation to pay O.P.M.'s assignee, LaSalle, amounts due under the equipment schedules. The equipment schedules

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8 See *In re O.P.M. Leasing Services, Inc.*, 21 Bankr. 993 (S.D.N.Y. 1982).
10 21 Bankr. 993 (S.D.N.Y. 1982).
11 Id. at 1006.
obligated O.P.M. to reimburse West Virginia for monthly maintenance charges for the leased equipment. The schedules provided that any breach of O.P.M.'s maintenance obligations would not affect West Virginia's duty to make monthly lease payments. When O.P.M. failed to pay the maintenance charges, West Virginia stopped paying under the equipment schedules. LaSalle sought enforcement of West Virginia's "hell-or-high water" obligation under the equipment schedule, despite the fact that both O.P.M. and West Virginia defaulted on their respective payment obligations.

The court found that the "hell-or-high water" provision mandated that West Virginia pay its rental obligations to LaSalle regardless of any defenses West Virginia had against O.P.M., including O.P.M.'s default in paying its maintenance obligations. The "hell-or-high water" clause was found to be neither illegal nor unconscionable, notwithstanding West Virginia's possible obligation to make double maintenance payments on the leased equipment.

In reaching its holding, the court stated, "to deny this clause its full force and effect would effectively reconstruct the contract contrary to the intent of the parties, which reconstruction would be impermissible." Furthermore, the court noted that such "hell-or-high water" clauses are essential to the equipment leasing industry: "To deny their effect as a matter of law would seriously chill business in this industry because it is by means of those clauses that a prospective financier-assignee of rental payments is guaranteed meaningful security for his outright loan to the lessor."

The Bankruptcy Court further held that the "hell-or-high water" clause rendered West Virginia's allegations that LaSalle took the assignment in bad faith with knowledge of claims and defenses irrelevant. LaSalle was granted summary judgment on the issue of liability on its counterclaim for accelerated rentals.

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12 Id. at 1005-08.
13 Id. at 1006-07.
14 Id. at 1006 (citing Rodolitz v. Neptune Paper Prods., Inc., 22 N.Y.2d 383, 386, 239 N.E.2d 628, 630, 292 N.Y.S.2d 878, 881 (1968)).
15 Earlier cases upholding "take-or-pay" contracts were based on the standard principle of contract construction that requires a court to ascertain and give effect to the parties' intent and consider the contract as a whole. See, e.g., Oliver-Mercer Elec. Coop., Inc. v. Fisher, 146 N.W.2d 346 (N.D. 1966) (contract for the supply of electricity, providing for payment of minimum annual charges for three years not a "requirements contract" under which a supplier agreed only to sell the amount of electricity actually used by a consumer, but rather an "availability" or "take-or-pay" contract); General Cable Corp. v. Citizens Util. Co., 27 Ariz. App. 381, 555 P.2d 350 (1976) (minimum charges for electricity required under "take-or-pay" contract neither void as against public policy nor illegal under state or federal law).
2. Force Majeure

The “hell-or-high water” contract involved in O.P.M. Leasing was an unconditional promise providing no exemption for any party’s failure to perform its contractual undertakings. Frequently, however, purchase contracts in project financings contain a force majeure provision excusing a party for delay or failure to perform in such events as fire, flood, acts of God, interference of civil or military authorities, and other contingencies. A force majeure provision ameliorates the harsh effects of a “take-or-pay” contract. When a force majeure provision is included in a “take-or-pay” contract, the contract’s enforceability usually depends on the language of the provision and how it is triggered.

Courts reject the argument that a change in governmental regulation constitutes a force majeure condition sufficient to relieve purchaser of its obligation under the contract. In making this determination, courts carefully scrutinize every clause and sentence of the force majeure provision to determine the intent of the con-

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17 A typical force majeure provision provides as follows:

*Force Majeure.* If by reason of force majeure either party hereto is rendered unable, wholly or in part, to carry out its obligations under this Agreement, and if such party gives notice and reasonably full particulars of such force majeure in writing or by telegraph to the other within a reasonable time as and to the extent that it is affected by such force majeure, shall not be liable in damages during the continuance of any inability so caused, provided such cause shall so far as possible be remedied with all reasonable dispatch.

*Definition.* The term “force majeure” as used herein shall mean acts of God, strikes, lockouts, or other industrial disturbances; act of a public enemy, earthquakes, fires, storms (including but not limited to hurricanes or hurricane warnings), crevasses, floods, washouts; arrests and restraints of the government, either federal or state, civil or military, civil disturbances, shutdowns for purposes of necessary repairs, relocation, or construction of facilities; breakage or accident to machinery or lines of pipe; the necessity for testing (as required by governmental authority or as deemed necessary by the testing party for the safe operation thereof), the necessity of making repairs or alterations to machinery or lines of pipe; failure of surface equipment or pipelines; accidents, breakdowns, inability of either party hereto to obtain necessary material, supplies, or permits, or labor to perform or comply with any obligation or condition of this Agreement; right of way; and any other causes, whether of the kind herein enumerated or otherwise, which are not reasonably in the control of the party claiming suspension. It is understood and agreed that the settlement of strikes or lockouts shall be entirely within the discretion of the party having the difficulty and that the above requirement that any force majeure shall be remedied with all reasonable dispatch shall not require the settlement of strikes or lockouts by acceding to the demands of an opposing party when such course is inadvisable in the discretion of the party having the difficulty.

*Limitations.* Such force majeure affecting the performance hereunder by either Shipper or Transporter, however, shall not relieve such party of liability in the event of concurring negligence or in the event of failure to use due diligence to remedy the situation and to remove the cause in an adequate manner and with all reasonable dispatch, nor shall such causes or contingencies affecting such performance relieve either party from its obligations to make payments as determined hereunder.

This provision was taken from a book located in the law office of Milbank, Tweed, Hadley & McCloy, New York, New York.
tracting party. For example, in *McLouth Steel Corp. v. Jewel Coal & Coke Co.*\(^\text{18}\) the parties entered into a “take-or-pay” contract for the sale of coke over a term of fifteen years. The contract contained a provision excusing the performance of both the seller and the buyer “... in the event, and during the continuance, of any action by governmental authority (whether now or hereafter effective) ...”\(^\text{19}\) Thirteen years after the contract was entered into, the Virginia Air Pollution Control Board ordered the seller to cease operating a particular plant. The court found that “no final [present] order” nor any possible future governmental action had prevented or appeared likely to prevent the buyer’s compliance with the contract.\(^\text{20}\)

Similarly, in *International Minerals & Chemicals Corp. v. Llano, Inc.*\(^\text{21}\) the Tenth Circuit held that compliance with a state environmental regulation did not excuse the buyer’s performance under the *force majeure* clause of a “take-or-pay” natural gas contract. The *force majeure* provision at issue exempted either party from performance “occasioned” by standard *force majeure* events (such as fire and flood) and required the party seeking to be excused from performance to immediately notify the other party of all pertinent facts and take all reasonable steps to prevent the occurrence of non-performance. The “take-or-pay” contract also contained an “adjustment of minimum bill” provision, permitting an adjustment of the buyer’s minimum purchase requirement if the buyer was “. . . unable to receive gas . . . for any reason beyond the reasonable control of the parties . . .”\(^\text{22}\)

The trial court rejected the buyer’s *force majeure* defense and found that the *force majeure* provision would excuse performance only if the governmental regulation made this purchase of the minimum amount of gas contracted for *absolutely* impossible or illegal.\(^\text{23}\) Although the court of appeals agreed with the trial court’s result it based its holding on other grounds. Looking to the particular language of the contract, the court of appeals noted that adequate notice was required to trigger the protection of the *force majeure* provision. Since the buyer gave the seller no reasons why gas consumption would be decreased, the court determined that the buyer failed to sufficiently inform the seller.\(^\text{24}\) The court also relied on the principle that “when a promisor can perform a contract in either of two alternative ways, the impracticability of one alternative does not excuse the promisor if performance by means of the other alternative is

\(^\text{18}\) 570 F.2d 594 (6th Cir. 1978).
\(^\text{19}\) Id. at 597, 608.
\(^\text{20}\) Id. at 608.
\(^\text{21}\) 770 F.2d 879 (10th Cir. 1985).
\(^\text{22}\) Id. at 882 (emphasis added).
\(^\text{23}\) Id. at 884.
\(^\text{24}\) Id. at 885-86.
still practicable." Thus, even if compliance with the governmental regulation prevented the buyer from taking the gas, it did not excuse the buyer's duty to pay.

3. Impracticability

To the extent that a contingency is not covered by a particular force majeure provision, the commercial impracticability defense may be available. Historically, courts have recognized that certain contracts can be voided by public policy because of impossibility, frustration of purpose, or mutual mistake of fact. Over the years these doctrines have merged to create a more general body of law on impossibility. The defense of impossibility or impracticability under Uniform Commercial Code (U.C.C.) section 2-615 applies to contracts involved in project financings. Comment 3 to U.C.C. section 2-615 states that the term "impractical" was written into the Code to

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25 Id. at 885 (citing Ashland Oil & Ref. Co. v. Cities Serv. Gas Co., 462 F.2d 204, 211 (10th Cir. 1972); Glidden Co. v. Hellenic Lines, Ltd., 275 F.2d 253, 257 (2d Cir. 1960); Restatement (Second) of Contracts comment f (1981).
27 For a discussion of the various doctrines and the historical development in this area, see, Comment, Relief from Burdensome Long-Term Contracts: Commercial Impracticability, Frustration of Purpose, Mutual Mistake of Fact, and Equitable Adjustments, 47 Mo. L. Rev. 79, 83 (1982).
28 U.C.C. § 2-615 (1978) provides:
   Except as so far as a seller may have assumed a greater obligation and subject to the preceding section on substituted performance:
   (a) Delay in delivery or non-delivery in whole or in part by a seller who complies with paragraphs (b) and (c) is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.
   (b) Where the causes mentioned in paragraph (a) affect only a part of the seller's capacity to perform, he must allocate production and deliveries among his customers but may at his option include regular customers not then under contract as well as his own requirements for further manufacture. He may so allocate in any manner which is fair and reasonable.
   (c) The seller must notify the buyer seasonably that there will be delay or non-delivery and, when allocation is required under paragraph (b), of the estimated quota thus made available for the buyer.
29 The U.C.C. has been adopted in every state except Louisiana. U.C.C. § 2-102 (1978) states that article 2 of the Code applies to the "sale of goods." U.C.C. § 2-105 (1978) defines goods as "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action." Electricity and fossil fuel products have been held to be goods under § 2-105. U.C.C. § 2-105 (1978); See, e.g., Amoco Pipeline Co. v. Admiral Crude Oil Corp., 490 F.2d 114 (10th Cir. 1974) (crude oil); Eastern Airlines, Inc. v. Gulf Oil Co., 415 F. Supp. 429 (S.D. Fla. 1975) (jet fuel); Oshey Gasoline Oil Co. v. OKC Ref., Inc., 364 F. Supp. 1137 (D. Minn. 1973) (gasoline); Hedges v. Public Serv. Co. of Ind., Inc., 396 N.E.2d 933 (Ind. Ct. App. 1979) (electricity); Mansfield Propane Gas Co. v. Folger Gas Co., 231 Ga. 868, 204 S.E.2d 624 (1974) (propane gas); Gardner v. Philadelphia Gas Works, 415 Pa. 415, 197 A.2d 612 (1964) (natural gas).
lessen the rigidity of the common law approach to impossibility. Despite this statement of the intent of the framers of the U.C.C., courts have been slow to retreat from their dim view of the defense of impossibility.

U.C.C. section 2-615 speaks in terms of "a seller" seeking to escape a breach of his duty on the ground of commercial impracticability. In a project financing, the buyer often wishes to avoid its "take-or-pay" obligations. In *Aluminum Co. of America v. Essex Group (ALCOA)* the court applied U.C.C. section 2-615 to a buyer's claim of impracticability. The court voided for impracticability a toll conversion service contract when the price of the contract goods rose substantially due to sharp increases in OPEC oil prices. Although the contract price was tied to OPEC oil prices, the parties never intended, at the time of contracting, that such a large increase in price would be enforced under the contract. Although *ALCOA* did not involve a "take-or-pay" contract, it indicates that courts may be willing to follow the intent of the drafters of the U.C.C. by liberalizing requirements for commercial impracticability.

In order to invoke the common law doctrine of impracticability, a three-prong test must be met. First, an unexpected contingency must have occurred which was not contemplated by the parties at the time the contract was entered into. Second, the party claiming impracticability must not have assumed the risk of the unexpected contingency either by agreement or by custom. Third, the performance of the contract must be rendered commercially impracticable due to the occurrence of the contingency.

Although the Tenth Circuit in *International Minerals* rejected the *force majeure* defense, the court voided the "take-or-pay" contract on the basis of impracticability under U.C.C. section 2-615. The court interpreted the word "unable" in the "minimum bill" provision to be synonymous with "impracticable," and found that the promulgation of the environmental regulation constituted an event "beyond the reasonable control" of the buyer. Thus, under the minimum bill provision, the buyer would not be required to pay for any natural gas not taken under the contract.

The court in *International Minerals* relied upon a Fifth Circuit decision, *Eastern Airlines, Inc. v. McDonnell Douglas Corp.* which ex-

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33 Id. at 76.
35 *International Minerals*, 770 F.2d at 886-87.
36 Id. at 887.
37 532 F.2d 957 (5th Cir. 1976).
amined a *force majeure* clause in light of U.C.C. section 2-615. In *Eastern Airlines*, McDonnell Douglas failed to deliver jet planes to Eastern on time due to its voluntary compliance with the U.S. Government's request to provide planes for use in the Vietnam War. McDonnell Douglas argued that under the *force majeure* provision of the contract, the war acted as a condition that excused delay. The Fifth Circuit held that the exclusion of a contingency in a *force majeure* clause does not prevent that contingency from being protected by U.C.C. section 2-615.38 Moreover, as a matter of law, governmental policy need not be mandatory to cause impracticability.39

Thus, the defense of commercial impracticability provides an "end run" around where a contingency is not addressed in the contract. The impracticability defense does not excuse a party's performance of its "take-or-pay" obligations if the party claiming impracticability assumed the risk of the unexpected contingency. The very existence of a "take-or-pay" clause in a contract indicates that the buyer has assumed risks such as inadequate capacity and decreased demand. A well-drafted "take-or-pay" contract that provides for payment regardless of the contract's unprofitability, failure of production or completion, or any other situation, affords a lender protection.

4. Regulatory Defenses

Another category of defenses recently asserted by natural gas purchasers involve certain regulatory defenses. The purchasers claim that their "take-or-pay" obligations under natural gas contracts violate the maximum lawful price provisions of the Natural Gas Policy Act (NGPA).40 The NGPA establishes a "maximum lawful ceiling price" for "first sale" gas.41 Purchasers argue that if they pay as required by a "take-or-pay" clause for gas not received, they violate the maximum ceiling price. The money paid divided by the volume of gas taken under the contract exceeds the regulated price, especially if deficient payments are not made up by subsequent takers of gas.

The maximum lawful price defense is an issue of first impression for the courts and the Federal Energy Regulatory Commission (FERC). Courts that have ruled on this issue have determined that payments under "take-or-pay" contracts for gas not taken or made up do not void the contract as a violation of "maximum lawful prices" under the NGPA. Furthermore, a district court may exercise

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38 Id. at 988-89.
39 Id. at 992-93.
41 Id.
its discretion to retain a case without either referring it to FERC or staying any of the proceedings.

In *Sid Richardson Carbon Gasoline v. Internorth* the plaintiff-producers sought to enjoin the defendant-purchaser from withholding twenty percent of the amount payable to plaintiffs for current sales of natural gas under certain “take-or-pay” contracts. The defendant contended that the plaintiffs’ sale of gas was a “first sale” within the meaning of section 3301(21) of the NGPA, and subject to the maximum lawful price ceiling for natural gas. The defendant contended that paying for gas that it did not take elevated the price of gas actually received beyond the lawful maximum price allowable under the NGPA. Allegedly, this situation was created because the “take-or-pay” deficiency payments were not made up during the contract’s five year recruitment period. The court stated that “although this creative argument has a certain sophistic appeal,” judicial authorities support the view that “take-or-pay” clauses are not void

   (A) The term “first sale” means any sale of any volume of natural gas—
      (i) to any interstate pipeline or intrastate pipeline;
      (ii) to any local distribution company;
      (iii) to any person for use by such person;
      (iv) which precedes any sale described in clauses (i), (ii), or (iii); and
      (v) which precedes or follows any sale described in clauses (i), (ii), (iii),
         or (iv) and is defined by the Commission as a first sale in order to prevent
         circumvention of any maximum lawful price established under this Act.
   (B) Certain sales not included. Clauses (i), (ii), (iii), or (iv) of subparagraph
       (A) shall not include the sale of any volume of natural gas by any interstate
       pipeline, intrastate pipeline, or local distribution company, or any affiliate
       thereof, unless such sale is attributable to volumes of natural gas produced
       by such interstate pipeline, intrastate pipeline, or local distribution company,
       or any affiliate thereto.
44 15 U.S.C. § 3314(b) (1982) provides:
   (1) General rule. The maximum lawful price under this section for any
       month shall be the higher of—
       (A)(i) the just and reasonable rate, per million Btu's, established by the
           Commission which was (or would have been) applicable to the first sale of
           such natural gas on April 20, 1977, in the case of April, 1977; and
       (A)(ii) in the case of any month thereafter, the maximum lawful price, per
           million Btu's prescribed under this subparagraph for the preceding month
           multiplied by the monthly equivalent of the annual inflation adjustment
           factor applicable for such month, or
       (B) any just and reasonable rate which was established by the Commission
           after April 27, 1977, and before the date of the enactment of this Act
           and which is applicable to such natural gas.
   (2) Ceiling prices may be increased if just and reasonable. The Commission
       may, by rule or order, prescribe a maximum lawful ceiling price, applicable
       to any first sale of any natural gas (or category thereof, as determined by
       the preceding provisions of this section if such price is—
       (A) higher than the maximum lawful price which would otherwise be ap-
           plicable under such provisions; and
       (B) just and reasonable within the meaning of the Natural Gas Act. (Nov.
under the NGPA. Thus, the court found that plaintiffs had established a substantial likelihood of prevailing on the merits in their breach of contract cause of action.

In *Koch Industries Inc. v. Columbus Gas Transmission Corp.* the court, following *Internorth*, rejected the defendant-buyers' maximum lawful price defense. The court noted that in addition to being contrary to recent case law, the maximum lawful price defense is unsupported by the NGPA regulations, specifically 18 C.F.R. section 271.504(a), which defines contract price. Under the C.F.R. regulation, a "take-or-pay" deficiency cannot increase the unit price of gas sold because that price is determined solely on the basis of gas that is actually delivered, not available but not taken. Thus, a "take-or-pay" contract controls when the seller is paid for the gas he sells.

5. Creditors' Rights

Even if "take-or-pay" agreements are enforceable, laws governing creditors' rights may limit the remedies of a lender relying on such agreements for repayment. Consider a typical case in which a project company debtor ("PC") enters into a "take-or-pay" contract ("contract") with a creditworthy sponsor ("S"). The rights of PC under the "take-or-pay" contract are then assigned to a lender ("L"). Under the laws of the United States, depending on the nature of the "take-or-pay" obligation and other terms of the contractual undertaking of S, it can be argued that (i) S's obligations under the contract are similar to those of guarantor, or alternatively, (ii) PC granted a security interest in PC's contract with S to L. Thus, L is entitled to the benefits of a guarantee by S of PC's obligation or to a secured party's status.

Under the Bankruptcy Code the different categorizations produce different results. If PC became the subject of a bankruptcy proceeding and S was a guarantor, L could still proceed against S for equitable remedies and/or contract damages pursuant to the terms

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46 The *Internorth* court cited the only case on point, *Southport Exploration, Inc. v. Producer's Gas Co.*, No. 83-CO550-BT (N.D. Okla., June 1, 1984), for this proposition. In *Southport* the defendant failed to "take-or-pay" for the minimum amount of gas contracted for, and also failed to make "take-or-pay" deficiency payments upon the seller's request.


48 The court also refused to recognize a common law commercial impracticability defense because Louisiana has not expressly adopted the U.C.C. The doctrine thus is not incorporated in the state's case law. See also Superior Oil Co. v. Transco Energy Co., CA No. 2138 (W.D. La. 1985).

49 18 C.F.R. § 271.504(a) (1985) defines the "contract price" as:

1. The total price paid per MMBtu for delivery of natural gas occurring on that date.
2. If no delivery of natural gas occurred under such contract on that date, the total price per MMBtu that would have been paid for delivery of natural gas on that date.

50 15 U.S.C. § 3301(22) (1982) defines delivery under the NGPA as "the physical delivery from the seller."
of the contract, and PC's bankruptcy should not affect S's obligation. Under the secured party categorization, PC could use the proceeds of payments made by S to PC, so long as L was given "adequate protection" under section 361 of the Bankruptcy Code. Since such a result could have dramatic effects on project revenue, the risk of that result merits a detailed review.

The bankruptcy of S would also severely affect the project. Upon becoming the subject of a proceeding in bankruptcy, S has the right to assume or reject the contract. If S assumes the contract, S has the right, notwithstanding any prohibition against assignment, to assign the contract to a third party. If, on the other hand, S rejects the contract, L has claim for damages against S (assuming the assignment is in proper form). However, the extent of damages which L can recover is not necessarily equal to the amount of the credit extended to the project. Instead, recovery depends on a variety of circumstances including the market price for fair market value of the product, and any mitigating cost savings resulting from the rejection of the contract.

If S were deemed to be a guarantor, L most likely would make a contingent claim in the bankruptcy proceeding against S for the amount L was unable to collect from PC. A court's categorizations are difficult to predict, but careful drafting and analysis of the various possible results should yield a set of risks most lenders would be willing to accept.

Post-completion enforceability issues in international project financing presents a plethora of issues not suitable for a general analysis. For each project the consequences of various choice of laws applications merit thorough analysis. Insofar as a project involves real estate issues or a mining exploration concession or lien, the law of the situs of the project governs the enforcement and ownership of any security interest. A direct mortgage on the project may not be possible under the laws of the situs jurisdiction, and the ownership, foreclosure and transferability of any security may be limited.

If the parties to a project find it advantageous, the law of a particular jurisdiction may be chosen as the governing law of the contract. However, if an obligor to any such contract is subject to the bankruptcy laws of a different jurisdiction, the bankruptcy laws of the governing jurisdiction, as well as the effect of such laws on the credit support for the project deserve careful analysis and review. The lender's goal is to have recourse to a credit risk on acceptable terms, for an amount not less than the amount of the total debt.

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IV. Conclusion

Management of international project finance involves a number of risks, both in the construction and operational phases. In the pre-completion phase, a concession agreement between the host government and the foreign sponsors of the project may serve to minimize certain economic and political risks. Lenders have recently sought to limit post-completion risks by utilizing "take-or-pay" or "hell-or-high water" provisions in contracts with project company debtors. These provisions require unconditional repayment of loans made to the project company. Although the U.S. Bankruptcy Court has upheld the use of "hell-or-high water" clauses, several options appear available that would mitigate their effect. Inclusion of a force majeure provision would exempt repayment under some circumstances, such as acts of God and interference by civil or military authorities. Impracticability of performance may be used as a defense to handle contingencies not covered by the force majeure clause. Regulatory defenses and traditional creditors' remedies may also be available to lenders involved in international project finance.