

When Good Projects Go Bad

Recent high profile difficulties faced by major contractors have once again put the spotlight on PFI contractual machinery and its ability to withstand external shocks. The demise of Ballast plc and more recently, financial difficulties faced by Jarvis plc, have caused authorities to examine their rights under PFI contracts in more detail. The typical scenario is a PFI project, which is half-way through the construction phase, when the main project sponsor or contractor runs into financial difficulties. As we have seen, this often sets off a chain reaction, with main contractor facing a cash flow crisis, it is unable to pay sub-contractors, suppliers and even key employees. They may walk off site, leaving the project running behind schedule, possibly facing liquidated damages claims and payment deductions for unavailability. These key 'ransom creditors' are unlikely to return to site unless they can be sure of receiving payment.

PFI is Different

When a PFI project runs into these difficulties, there are two groups of people who have a strong incentive to sort out the mess. Firstly, the equity investors. They may have invested up to 10% of the capital value of the project through a combination of shares and subordinated debt. Usually, they stand to make no return on their investment until the new facilities are built and open for business – which then triggers payment of the unitary charge. If they sit back and do nothing, they may ultimately lose the whole of their investment. If the senior lender decides to 'step in', he will normally take control of the project company and the investor's shares. He will use shareholders' funds first to rectify any problems.

What can the equity investor do in these circumstances? If he is an arm's length investor, unconnected with the main contractor, he may have some recourse against the defaulting party. This could be through a shareholders agreement, parent company guarantee or performance bond. These may enable him to seize control of the project and raise additional funds to rescue the project. Ultimately, he may have to inject further investment of his own to rectify the problems. They may seek assurances from the Authority before doing so.

Where additional funds are being injected or key project sub-contractors are being released from their obligations, this may cause Authorities to examine whether clauses dealing with refinancing have been triggered. Usually though, a rescue refinancing will not trigger an accelerated distribution to investors and so they may be of limited relevance.

Senior Lender as White Knight?

If the project is severely delayed and not generating a revenue stream, it is very likely that the project company will soon be in default of its loan covenants with the senior lender. If a default event occurs, the senior lender has a range of remedies at his disposal. To begin with, he may impose a tighter monitoring and payment regime and commission urgent status reports; next the debt repayments may be accelerated and his ultimate sanction is to step into the project and control it. Senior lenders will have a variety of recourse against the main sub-contractors: these will include performance bonds, guarantees and warranties from underlying sub-contractors. In the recent restructuring of

Jarvis' PFI portfolio, the FT reported that the bondsman was persuaded to allow the construction performance bond to be called early to release funds into the PFI project, in return for the bondsman enjoying a cap on his liability going forward.

Step-in will be the last resort for the lender: he will be keen to avoid assuming operational control of the project if at all possible, because of the added risks it brings. He may instead work to effect a reorganisation of the key sub-contractors who are in default. This could mean replacing the building sub-contractor and/or the FM provider. All of this takes time and costs money. There is no guarantee that the market will respond to taking on a sub-contract on the same terms and price – which would leave the project company out of pocket.

Authorities may be faced with requests to approve a change in sub-contractors. There will normally be clauses in the contract regulating such a change. Relevant considerations for an Authority faced with a request would include - what is the track record and financial capacity of the proposed replacement, on what terms will the newcomer take over and what are the exit terms for the outgoing contractor? Who will be responsible for building defects going forward? If the original builder is released from his obligations, what redress would there be in future for defective work? One possible solution might be for the Authority to insist that a building defects insurance policy is put in place. What will be the effect on any direct agreements or warranties which the Authority enjoys with underlying sub-contractors or design professionals?

What Can the Authority Do?

All the while, the Authority may be facing severe operational disruption. Key facilities have failed to open on time – leading to increased cost of operation. What remedies does the Authority have in these circumstances? The first key remedy unique to a PFI contract is that ordinarily, payments should not start to flow to the project company until the facilities are open for business. Authorities should think carefully before agreeing to make large payments earlier than this, since a large bargaining chip will be removed. If payments are already being made, but the contractors' failure to rectify problems is causing rooms to be unavailable or performance of FM services to be below the required standard, the payment mechanism provides a remedy in the form of payment deductions. Usually, there will be a clause in the contract specifying that the payment mechanism is the Authority's sole remedy for non-performance. If there is not, the Authority may wish to consider whether it has a general right of set-off against payments otherwise due to the project company in relation to the losses caused or other debts due to the Authority (e.g. payments under Section 106 agreements). Some project agreements may also contain provisions entitling the Authority to deduct liquidated damages at a specified rate per week for losses caused to the Authority.

Other Remedies to Consider

Most PFI contracts will contain a clause entitling the Authority to 'step in' and carry out certain aspects of the project itself. Normally, the circumstances where this is allowed are tightly defined. For example, the standard schools contract allows the Authority to step in only where there is an immediate threat to health and safety or the performance of a statutory duty is being prevented. In these circumstances, an Authority might legitimately bring in its own contractor to carry out emergency repair works or deliver certain key services. However, this course of action is not without risk. To step in and assume operational control is transferring some of the project risk back to the Authority. Consideration would also have to be given to the effect on project insurances and supplier warranties if the Authority or another contractor goes on to the site. This should really be a last resort and a step taken only following consultation with project funders.

Some authorities may be fortunate enough to enjoy some form of direct recourse against project sub-contractors. This may be in the form of a direct agreement or a collateral warranty. It is worth checking these to see what rights may be available - although in practice the rights may be subordinated to those of the senior lender – meaning that he has first bite at the cherry.

The Ultimate Sanction – Termination

An Authority may get to the point where it has no confidence in the ability of the sponsors to rescue the project. Performance may be so bad, that one or more of the grounds for termination of the contract may be satisfied. It is worth considering what the possible sequence of events might be in these circumstances. If the Authority issues a termination notice to the project company, there may be a final remedy period for the project company. The senior lender must normally be copied into a termination notice, under the terms of the Direct Agreement. The service of a notice would trigger an immediate right for the lender or his representative to take control of the project. It must be remembered that under a typical direct agreement lenders may enjoy a period of up to 2 years in which to rescue the project. However, if further defaults do occur during their period of step-in, the Authority may proceed to terminate afresh.

In these circumstances, the Authority may ultimately be faced with an obligation to pay substantial compensation for lost capital investment in the project assets. In contracts drafted on the basis of SOPC Guidance, there will be a test as to whether a re-tendering applies (i.e. the contract is sold in the open market and the outgoing contractor and his funders receive whatever sum can be generated from the sale as their compensation) or, if the lenders can demonstrate that there is no 'liquid market' (i.e. no fewer than 2 willing bidders for PFI type contracts) then the compensation is assessed by an independent expert and is payable by the Authority from its own resources. Consequently, termination should be seen as a last resort.

Other factors to consider in a termination would include – where will the Authority obtain the capital to make a termination payment? Is 'prudential borrowing' an option? Would the income streams necessary to support repayments continue despite the termination (e.g. PFI credits from central government or third party contributions). What will be the state and condition of assets at the point of handback, what will happen to the workforce – are warranties in place and could a retention be made from payment until the Authority is satisfied with the condition and potential liabilities?

Conclusions and Practical Steps

Where a project runs into financial difficulties, it will undoubtedly test relationships to the limit. The parties involved should avoid precipitate action. They should carefully examine in conjunction with professional advisers the package of contractual rights which they enjoy and engage in early constructive dialogue with all key participants in the project. Open and effective communication is vital at this stage, as rumours often abound in the marketplace. Key stakeholders need to be kept properly informed of what is happening to avoid their taking matters into their own hands.

A properly drafted PFI contract package should serve to insulate Authorities from the financial consequences of the failure of a key supply chain member – though some operational disruption is almost inevitable. Unlike many conventionally procured projects, the project investors and senior lenders have a powerful incentive to step in and rescue a project. The strength of constructiveness of relationships on the ground will make all the difference at this testing time.

