

Project Finance Boosted by Effortless Pledge Enforcement

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As we witness a global drop down in oil prices, Kuwait, as an oil-dependent economy, currently has no choice but to adopt a new approach for the purpose of ultimately diversifying its economy in upcoming years.

On that basis, a great step was taken by the Kuwait legislature to reform the Capital Market Authority Law No 7 of 2010 (the "Law") by promulgating the new Capital Market Authority Resolution No. 72 of 2015 (the "By-laws"), which came into force on 10 November 2015 and, in our opinion, incorporated with many constructive changes into Kuwait's Capital Market laws. These amendments will boost the investment sector in Kuwait, and will encourage investors to extensively engage with more exposure in the Kuwait market through entry into the capital market. Indeed, commercial lenders are one of the main players that are likely to increase their exposure in the Kuwaiti market, as they will have more confidence in the new legal framework for the Kuwait capital markets as set out by the By-laws. More specifically, the project finance sector will likely flourish on the basis of the By-laws permitting parties to collateralise shares, which are one of the most important types of collateral that might be taken to secure project finance loans.

This article discusses the role of project finance loans as a means of raising funds on a limited recourse basis to the extent that a lender can primarily look into projected cash flows of that project as a security in addition to the suitable collateral typically taken under these kind of loans (i.e. pledge over shares) and how the By-laws indirectly boost this sector of financing.

Project Finance

A 'project' is usually a large-scale, capital-intensive and long-lived collection of assets, liabilities, and related construction and operation contracts. Project finance is raising of funds on a limited recourse or non-recourse basis to finance an economically separable capital investment project in which the providers of the funds look primarily to the 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. In other words, project finance is the extension of credit to finance an economic unit where the future cash flows of that unit serve as collateral for the loan. This is done primarily by facilitating the separation of project assets from the sponsor and enabling the financing of those assets on the basis of the cash flows they are expected to generate. Moreover, project finance can allow a sponsor to undertake a project with more risk than the sponsor is otherwise willing to underwrite independently. Project finance can also help sponsors avoid incurring leverage beyond tolerable levels, thereby helping them preserve their debt capacity, credit ratings, and cash flows for alternative capital investment activities.

Funding by Commercial Banks

Commercial banks are the largest providers of funds for large-scale, capital-intensive projects, often accounting for as much as 50 percent of the overall project funds and up to 100 percent during pre-completion. Project loans from banks generally take the form of senior loans, both secured and unsecured.

Senior secured project loans generally give banks a security interest in the core assets of the project. Typical forms of collateral pledged to creditors in senior secured project loans include real estate, an assignment of insurance proceeds, and a pledge over shares. In light of the fact that Kuwait's laws are very conservative with respect to enabling a borrower to grant a real estate mortgage in favour of a lender, particularly if that lender is a foreign bank, the pledge over shares has become the most essential collateral to secure project finance loans especially during the pre-completion stage.

As such, lenders frequently require sponsors to pledge their shares in the project company as a part of the loan security package. This is important if lenders feel that the value of the mortgaged assets is insufficient or there is uncertainty about the enforceability of other mortgages. Therefore, the pledge of shares in Kuwait is important collateral for project finance due to the legal and practical barriers that hinder the collateralisation of real estate in addition to the uncertainty about its enforceability. On the other hand, effectuating a pledge of shares is generally a relatively simple procedure and, once obtained, can be a useful negotiating tool for lenders. When sponsors pledge their shares to lenders, the lenders may take control of the borrower company in the event of default and may take the steps necessary to protect their investment.

Impact of By-laws

The CMA Bylaws have greatly improved the legal environment for project finance deals in Kuwait by streamlining the process of enforcing a pledge of shares. In particular, Article 9-13 of Book Eleven of the By-laws provides that where the creditor or mortgagee is a bank or financial institution and the debtor or mortgagor is a professional client, the parties may enter into an agreement at the time of concluding the pledge contract or at a later date to give the creditor or mortgagor the right to acquire or sell the pledged asset in the event of the debtor's breach of its obligations. In exercising this right, the creditor or mortgagee does not need to adhere with the provisions stated under Articles 231 to 233 of the Trade Law (Law No. 68 of 1980) or the provisions stipulated under Book 3 of the Civil and Commercial Procedures Law (Law No. 38 of 1980).

Also, Article 9-14 of Book Eleven of the By-laws provides that, where the creditor or mortgagee has exercised its right under Article 9-13, the investment portfolio manager and clearance agency, as applicable, shall execute the instructions issued to them by the creditor or mortgagee for the acquisition or sale of securities and satisfy the right of the creditor or mortgagee. This is subject to the debtor and in-kind guarantor, if any, being given written notice in accordance with the pledge contract at least five business days before the date of acquisition or sale. Further, the sale may not include more securities than are sufficient to settle the right of the creditor or mortgagor.

In our opinion, these articles constitute a major reform in the usual enforcement process for pledges of shares. With the By-laws, we now have a straightforward process of enforcement whereby a party can merely notify the debtor or mortgagor and in-kind guarantor with five business days prior written notice and thus easily transfer the pledged shares in its favour. As such, the creditor or mortgagor only needs to apply to the Kuwait Clearance Company to transfer the title of these shares, whether in its favour or to any third party as chosen by the creditor or mortgagor. Prior to the implementation of Articles 9-13 and 9-14, a lender would have to struggle through a very long process of court enforcement procedures as previously set out under the Kuwait commercial and procedural laws. It is further of note that the By-laws explicitly exclude the previous approach of enforcement by setting aside the provisions of the commercial and civil procedural laws. As a key characteristic of the new By-laws, there is no need now to liquidate pledged shares through a public auction so that the proceeds of the auction can be distributed to the lender. The requirement of an auction is now repealed by the direct transfer of shares to the creditor or mortgagor or to any third party. As such, the lender may take control of the borrower company in the event of default and may take the steps necessary to protect its investment or to obtain its proceeds directly under an effortless enforcement process.

Conclusion

As a pledge over shares in Kuwait constitutes the most essential security that might be taken to secure a project finance loan, the By-laws, including the enforcement process, will have a significant impact on project financing in Kuwait. This is expected to give investors an appetite to step into the Kuwait market with more assurance.