Project finance lenders may seek protection under international investment treaties against state measures adversely affecting the project

Executive summary

- On 20 August 2020, an investor-state arbitral tribunal has for the first time held that project finance (in the form of long-term loans and swaps) constitutes a protected "investment" under an international investment treaty (here, the Energy Charter Treaty).
- The claim, brought by the German financial services provider Portigon AG (formerly WestLB), arose out of Spain's drastic changes in 2013-2014 to the renewable energy incentive regime, which had been the basis for Portigon AG's financing of over 30 renewable energy projects in Spain.
- Spain's repeal of the incentive regime adversely affected the cash flow available to the renewable energy projects, impairing their creditworthiness, and thus the value of the financing.

Project finance as a protected investment

Project financiers bear a significant share of the commercial and investment risk for developing and operating energy, infrastructure or industrial projects through highly leveraged, non-recourse long-term financing. The success of each project finance transaction will often solely depend on the project's ability to generate future cash flows to repay the financing. If, for whatever reason, project revenues decrease significantly, the project finance lenders will have no or limited recourse against other parties. Although contractual termination rights are typically available in such circumstances, they are unlikely to provide an effective remedy if the revenue shortfall is due to developments beyond the control of the project company.

The typical scenario of external developments beyond the control of the project company are revenue shortfalls caused by regulatory measures taken by host States.

In cases where lenders have no direct legal relationship with the host State, it was unclear whether they would benefit from the same protections as equity providers. This picture has changed significantly with the recent ground-breaking jurisdictional decision in *Portigon AG v Kingdom of Spain*. For the first time, financing provided by a third party lender to a project company (and not directly to the State) has been considered a protected investment under an international investment treaty.

Project finance lenders may now have recourse to international arbitration directly against sovereign States, in situations where State-imposed measures adversely affect a project they financed.

International investment treaties stipulate specific protection standards for the benefit of foreign investors and typically provide for the possibility to have recourse to international arbitration directly against the government of sovereign States. The protections notably apply in situations where State-imposed measures adversely affect the ability of a foreign investment to generate cash flows. In other words, if the host State, through legislative, administrative or even judicial acts, breaches the treaty and thereby impairs the foreign investment, it must pay compensation. According to the decision in *Portigon AG v Kingdom of Spain* such protections also extend to project financing and project finance lenders.

What should lenders keep an eye on?

In order to ensure recourse to investment treaty protection is available when needed, it is vital for lenders to take certain elements into account from the outset of a project financing:

- **Applicable international investment treaties:** investment treaty protection depends on the nationality of the party claiming protection (in this case, the lender). Providing the financing through the parent company or its branches or subsidiaries incorporated in different jurisdictions may have a significant impact on the investment protection available. A preliminary legal due diligence on the array of treaties available is therefore advisable.
- **Reliance on State commitments:** as a third party to the relationship between the State and the project sponsors, it is important for lenders to keep a detailed record of any documentary evidence showing their reliance on certain State commitments (eg due diligence reports on statutory tariffs, governmental permits as conditions precedent, where available). Any direct interaction between the State and the lender will foster the lender's claim even where formal direct agreements with governmental agencies may not be available.
- **Transfer of the assets:** it is common for lenders to syndicate the financing with other financial institutions or securitize it and assign it to third parties. In these instances, utmost care must be placed on the language of the legal instruments used to syndicate, assign or transfer the financing in order to preserve treaty protection and clarify the entity (or entities) that can avail themselves of it.

How can we help?

We have extensive experience advising investors in disputes against sovereign States, particularly in the financial sector. In fact, it was a Freshfields team that secured the favourable jurisdictional decision in *Portigon AG v Kingdom of Spain*; the decision is further testament to the strength of our international arbitration and financial institutions practice groups. Moreover, we have the required financing expertise to ensure the best setup for your project finance. We would be delighted to explore with you how this significant development in international investment law may help you to further safeguard your project finance investments.

Please find our contact details below and on the following page:

International Arbitration

Boris Kasolowsky
Partner
Continental Europe
T +49 6927 308747
E boris.kasolowsky@freshfields.com

Carsten Wendler
Partner
Continental Europe
T +49 6927 308207
E carsten.wendler@freshfields.com

Erin Miller Rankin
Partner
London/Middle East
E erin.millerrankin@freshfields.com

Oliver Marsden
Partner
London
T +44 20 7785 2219
E oliver.marsden@freshfields.com

Noiana Marigo
Partner
US/the Americas
T +1 212 284 4969
E noiana.marigo@freshfields.com

Nicholas Lingard
Partner
Asia
T +65 8183 0169
E nicholas.lingard@freshfields.com

Contacts (continued)

Financial Institutions Disputes

Simon Orton
Partner
London
T +44 20 7832 7671
E simon.orton@freshfields.com

Kim Zelnick
Partner
US
T +1 212 27 7 4010
E kimberly.zelnick@freshfields.com

Tim Mak
Partner
Asia
T +852 2913 2668
E tim.mak@freshfields.com

Moritz Pellmann
Partner
Continental Europe
T +49 692 73 08 855
E moritz.pellmann@freshfields.com

Finance/Project Finance

Tim Pick
Partner
London/Middle East
T +44 20 7832 7115
E tim.pick@freshfields.com

Gabriel Mpubani
Partner
London/Africa
T +44 20 7716 4101
E gabriel.mpubani@freshfields.com

Melissa Raciti-Knapp
Partner
US/the Americas
T +1 212 27 7 4035
E melissa.raciti@freshfields.com

Anna Nersesian
Partner
Russia
T +7 495 785 30 64
E anna.nersesian@freshfields.com

Thomas Ng
Partner
Asia
T +852 2913 2617
E thomas.ng@freshfields.com

Don Stokes
Partner
Asia
T +65 9069 6349
E don.stokes@freshfields.com

Daniel Reichert-Facilides
Partner
Continental Europe
T +49 692 73 08 135
E daniel.reichertfacilides@freshfields.com

Gabriela Gomes Strieder
Counsel
Continental Europe
T +49 69 2730 8113
E gabriela.gomes@freshfields.com

freshfields.com