

Possibility to use and enforce lender's step-in rights in Baltic PPP projects: part one — Estonia

Jun 08 2010 Jane Eespõld, Reimo Hammerberg, Rûdolfis Eðielis, Agnë Jonaitytë, Vidas Rudoka and Liudas Ramanauskas

As the possibility to use and enforce lender's step-in rights is of crucial importance for the financing of public-private partnerships projects, this series provides an overview of Estonian, Latvian and Lithuanian legal environments in that respect. Step-in rights are particularly important for lenders as it gives lenders control over a project's cash-flow, which is in fact the most important security for lenders. Where a lender has been granted step-in rights, the lender has a chance to cure the breach and thereby avoid termination of the contract and related cash-flow. In international practice, step-in rights may take the following two main forms:

- i. Right to replace the defaulting private partner with another private partner (i.e., transfer of contracts from the defaulting private partner to a new private partner suggested by the lender).
- ii. Right to take control of the performance of the defaulting private partner by acquiring shares of the private partner.

The main issues in respect of using and enforcing lender's step-in rights in Estonian, Latvian and Lithuanian PPP projects arise in the context of public procurement; however, contractual, corporate and insolvency law issues are also relevant when using and enforcing step-in rights. Each summary provides an insight into the different PPP regulatory landscapes of the three Baltic states and a summary of those issues related to step-in rights that are common for all three jurisdictions and those that are not. Despite the fact that financing infrastructure objects through PPP projects is an increasing trend in Estonia, legislation in that respect is still in the development phase. Unlike neighboring state Latvia, Estonia does not have specific legislation for PPPs and, therefore, PPP projects are subject to the general legislative framework. Competitive dialogue and concessions that favor the use of PPP, however, are regulated in Estonian law.

Public procurement issues

The Estonian Public Procurement Act does not address step-in rights. Basically, the regulation of the PPA ends with the conclusion of the public contract. Using and enforcing step-in rights under effective legislation has also not been tested in courts. There are certain provisions in the PPA, however, that regulate amending the public contract. Namely, under the PPA, the contracting authority (public partner) may agree an amendment of the awarded

public contract only in the case the amendment is due to objective circumstances which could not be anticipated by the contracting authority during the award of the public contract and, in the case of leaving the public contract unchanged, the achievement of the objective set with the public contract would be fully or in material partly in danger. The contracting authority may not agree on amending the public contract, if the objective of the amendment could be achieved with the award of the new public contract.

Estonian law is silent about whether changing a party to the contract or party's shareholder could be deemed as an amendment of contract. Based on a European Court of Justice ruling, however, it could be concluded that the changing of a party to the contract would, as a rule, be deemed as an amendment to an essential term of the contract, whereas any changes to the composition of the shareholders in a contractual partner would not, as a rule, result in a material contractual amendment. Replacing a private partner would, therefore, also in Estonia be probably regarded as an amendment of a public contract, whereas taking control of a private partner would not probably be deemed to result in a contractual amendment. It is questionable whether the replacement of a defaulting private partner would be considered as a permitted amendment of a contract under the PPA. As circumstances when step-in rights are typically exercised (i.e., defaulting under various project contracts) could be usually foreseen at the outset of the project, it could be concluded that such replacement would probably not be deemed as unforeseeable and a permitted amendment. In the case that such replacement would be considered as a prohibited amendment of the contract under the PPA, a lender would have step-in rights only in the form of taking control over the private partner's shares.

The PPA does not provide for a regulation in respect of amending a concession contract. As the principles of transparency and equal treatment apply also to granting concessions, however, the above restrictions of the PPA on amending public contracts most probably apply also to the use and enforcement of step-in rights in concessions. Exercising step-in rights in violation of the above regulation of the PPA would not render the contract void, i.e., the contract would still be valid; however, the public authority could be held liable for violation of the requirements of carrying out public procurement. As step-in rights are crucial for the PPP project to get funding and Estonian law does not address step-in rights, the solution could be to provide clear step-in rights in the PPA. Such step-in rights should enable the lender to replace, with the consent of the public partner which should not be unreasonably withheld, the defaulting private partner with a new private partner who meets the requirements initially established for the private partner.

Contractual law issues

Contractual law issues become relevant in cases where the lender wishes to use step-in rights to replace the defaulting private partner in contracts with another private partner. Estonian contract law does not hinder the use and enforcement of step-in rights. To transfer contracts from the defaulting private partner to another private partner, consent of the other party to the contract (public partner) is required. It is possible and advisable to take such public partner's consent in advance, i.e., such consent can be included in the initial contract. In the case of transferring contracts, risk of transfer of enterprise arises. Under Estonian law, by taking over the things and rights that belong to an enterprise, all transferor's obligations related to the enterprise also transfer automatically to the transferee. The economic substance of the transfer of enterprise would, therefore, be comparable to the transfer of shares of a private partner.

Corporate law issues

Corporate law issues become relevant in cases where the lender wishes to use step-in rights to take control of the performance of the defaulting private partner by acquiring the private partner's shares. Estonian corporate law does not hinder the use and enforcement of such step-in rights. Some formal requirements should, however, be taken into account when exercising step-in rights for the acquisition of the private partner's shares from the sponsor. Namely, assuming that the share(s) of the private partner are registered with the Estonian Central Register of Securities, transfer of ownership must be registered in the ECRS to be valid towards third persons. To register transfer of shares in the ECRS, the lender or its nominee must have a securities account open in the ECRS. If the private partner's share(s) are not registered in the ECRS, the share transfer agreement must be concluded in notarised form. It is also possible that the sponsor does not own the majority of the private partner's shares, but exercises control over the private partner on the basis of a shareholders agreement. In such case, in addition to the private partner's shares, the shareholders agreement should be transferred to the lender to acquire control of the private partner.

Insolvency law issues

If an Estonian private partner is declared bankrupt, the bankruptcy trustee, who is an independent official appointed by the court, would gain control of the property and the affairs of the insolvent private partner. If the private partner has also other creditors, lenders under the PPP project would not have the ability to direct the bankruptcy trustee fully to their desired course of action, since the bankruptcy trustee must act for the benefit of all creditors. As there is a risk that a lender's right to enforce its step-in rights in the form of the transfer of contracts from the defaulting private partner may be restricted in bankruptcy proceedings, the solution for the lender would be to exercise its step-in rights prior to the declaration of bankruptcy. The other option for the lender would be to purchase or satisfy claims of other creditors before the declaration of bankruptcy and thereby avoid the private partner's bankruptcy proceedings.



Jane Eespõld is a senior associate in SORAINEN Estonia office. Reimo Hammerberg is a partner in the same office and heads SORAINEN's regional Banking & Finance team. Rūdolfs Eðielis is a partner in SORAINEN Latvia office and heads its Banking & Finance team. Agnė Jonaitytė is a senior associate in SORAINEN Lithuania office. Vidas Rudokas is a senior associate in SORAINEN Lithuania real estate team. Liudas Ramanauskas is a senior associate in SORAINEN Lithuania office.