The Commercial Law Development Program
Presents
Public-Private Partnership Webinar Series

Project implemented by:

Public Private Partnerships: Termination

Today’s Presenters

- **Shemane Chan**
  Partner

- **Loh Yong Hui**
  Senior Associate

RAJAH & TANN ASIA

LAWYERS WHO KNOW ASIA

Open Floor for Questions

Please use the chat box to submit a question, or use the ‘raise hand’ feature. If you raise your hand, you will be invited to unmute and ask your question.

Kindly keep yourself on mute unless asking a question.

Agenda

01 Overview

02 Termination Steps

03 Private Partner Default

04 Authority Default

05 Neutral Event Termination

06 Voluntary Termination

1. Overview

Introduction

PPP projects run for a significant period of time, typically, between 15 to 30 years.

Difficult to cover the entire range of possible events that may arise during the PPP project.

Authority's dilemma

Protecting public sector interests

vs.

Ensure continuous provision of public services

Key Considerations

1. Whose fault is it?

2. What constitutes a termination event?

3. When must notice be given and the process starts?

4. How will the non-defaulting party be compensated?

5. What are the other consequences?

Termination in PPP Contracts

- Importance of a well drafted termination clause :

1. Reducing uncertainty to ensure greater value-for-money end results

2. Clarity on the process arising from a party's failure to fulfil key obligations

3. Proper and detailed compensation

4. Optimal sharing of risks that is mutually acceptable

Termination Data

Region	Termination by PA	Prevalence (%)	Termination by PC	Prevalence (%)
Europe	2	4%	0	0%
Latin America and the Caribbean	3	5%	2	4%
MENA	1	7%	0	0%
South Asia	4	10%	1	3%
Total	**10**	**5%**	**3**	**2%**

Table 10: Breakdown of termination by party

https://managingppp.gihub.org/data/other-prominent-issues/termination/

2. Termination Steps

Termination Flowchart
(Traditional Government Procurement Contract)

Default event

↓

Non-defaulting party gives notice of default

↓

Defaulting party to rectify default during cure period

If default is rectified, → No entitlement to terminate

↓ If default is not rectified,

Non-defaulting party may serve termination notice

↓

Termination consequences
(eg: termination payment)

Termination Flowchart (Public-Private Partnership Contract – Private Partner default)

Default event

↓

Non-defaulting party (i.e Authority) gives notice to defaulting party (i.e. Private Partner) and lenders

↓

Defaulting party to rectify default during cure period

If default is rectified, → No entitlement to terminate or step-in

↓ If default is not rectified,

Lenders may serve **step-in notice** to the defaulting party to rectify the default on its own or via a third party contractor

If no step-in notice, → Non-defaulting party may serve termination notice

↓

Termination consequences (eg: termination payment)

↓ If default is rectified

No entitlement to terminate or step-in

↓ If default is not rectified,

Non-defaulting party may serve termination notice → Termination consequences (eg: termination payment)

Step-in Notice Flowchart

Lender may serve a **step-in notice** to the defaulting party (i.e. private partner)

During the step-in period

Authorised representative (appointed by Authority)

- Entitled to exercise the rights of the private partner during step-in period
- Acts by authorised representative will also bind the private partner
- Entitled to step-out any time after step-in date and will be released from all liability thereafter

Substitution of the private partner

- Private partner, authority and lender will enter into a novation agreement with a substitute (new private partner) nominated by the lender
- The substitute shall become a party to the PPP contract in place of the private partner and assume all of its obligations

Lenders’ Step In Rights

- Lenders’ step-in rights are important for the bankability of PPP projects.

- They give the lenders the ability to rescue a project if the Private Partner has defaulted on one of its key obligations by taking remedial action before the Authority terminates the contract.

- In doing so, lenders will aim to protect their loan.

- Step-in typically involves the appointment of a suitable substitute Private Partner.

3. Private Partner Default

Compensation for Private Partner default

Three basic approaches commonly seen in PPP contracts:

‘Market value’ approach – In this approach, compensation is driven by the market value of the contract at the point of termination.

‘Book value’ approach – Compensation is based on the actual investment costs incurred for the construction of the project.

‘Debt’ approach – Compensation is calculated by reference to the senior debt outstanding at the time of termination.

Private Partner Default

The PPP contract should set out the grounds on which the Authority may invoke termination for default of the Private Partner. Examples of a list of default events by Private Partner:

1) insolvency/ bankruptcy of the Private Partner

2) failure of the Private Partner to reach certain construction milestones or project completion

3) failure of the Private Partner to deliver the services according to the agreed specifications

Insolvency

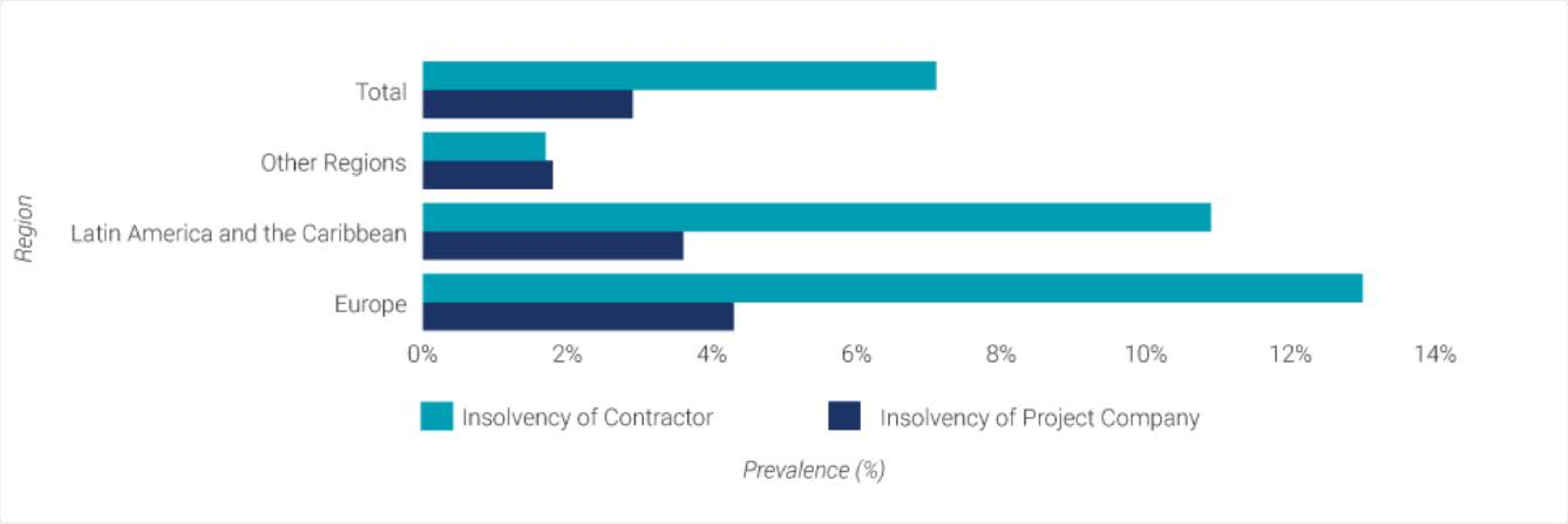

Figure 15: Insolvency Events, based on 204 projects with data available

Note : Data obtained from https://managingppp.gihub.org/data/other-prominent-issues/insolvency/

Private Partner Default

Examples of a list of default events by Private Partner:

4) penalty points (awarded for intermittent failures to deliver services) that exceeded specified thresholds

5) Change of ownership of the Private Partner without consent of the Authority

6) Failure to insure the PPP project as required under the PPP contract.

Factors of Consideration

When negotiating Private Partner default provisions, the Authority should consider the following:

- **Improving bankability and reducing uncertainties** – Defining clear and objective Private Partner default events ensures greater predictability for the Authority and reduces the risk of contractual disputes. A tightly defined list of events will improve bankability and encourage greater interest from private sector investors.

- **Private Partner's preference** – The Private Partner will in general have a strong preference for clear definitions of all events/actions as well as the process that lead to Private Partner default (e.g. itemised list) and will resist ambiguous contract wording and catch-all provisions.

Factors of Consideration

When negotiating Private Partner default provisions, the Authority should consider the following:

- **Authority's interest** – The Authority will tend to favour a long list or open-ended list of default events to ensure that it has control over situations that were not foreseen when the contract was signed. Although a degree of generic default definition may help to cover all possible scenarios, the Authority should aim to be as precise as possible in identifying which events constitute a default.

- **Allocating risks to the party best able to manage them** – It is important to ensure that the events that trigger a Private Partner default only cover the risks which the Private Partner has taken responsibility for under the PPP arrangement.

Factors of Consideration

When negotiating Private Partner default provisions, the Authority should consider the following:

- **Incentive vs. sanction** – The Private Partner default events should be determined in a way that strikes a balance between incentive to perform and sanction for failure. The Authority should avoid overly prescriptive regimes, since this can increase the perceived risk for the Private Partner and translate into a higher contract price.

- **Materiality thresholds and cure periods** – Private Partner events of default should be qualified by appropriate materiality tests and be subject to cure periods.

- **Repeated minor breaches** – The Authority will need to address the question of repeated minor breaches by the Private Partner and the extent to which these should give rise to contract termination. This may involve introducing a warning notice/penalty point mechanism.

Compensation for Private Partner default

The Authority is not always required to compensate the Private Partner following termination for its default.

However, a no-compensation regime creates **fairness** issues

(i.e. the Authority would be getting a windfall) and makes it difficult to attract investors and lenders.

As such, PPP contracts typically contemplate some level of compensation payment following termination for Private Partner default.

Sample Provision (Termination upon Private Partner Default)

2. Termination upon Private Partner Default

If the Contracting Authority terminates this PPP Contract in the event of a [*Private Partner Event of Default*][45], the Contracting Authority shall pay to the Private Partner a compensation amount equal to [*80 to 85*][46] %[47] of the Outstanding Senior Debt.

Source: Report on Recommended PPP Contractual Provisions 2015 published by World Bank Group

How and when to pay compensation?

The Authority should consider the following points:

Authority's interest – The Authority will often prefer paying compensation amounts over time since a lump sum would result in a large outflow of funds that may not be budgeted for or have treasury coverage.

Private Partner's interest – In the event of termination for Private Partner default, the lenders are likely to be the only private party benefiting from Authority compensation. The lenders will resist payments over time, as they may be reluctant to be exposed to a project whose contract has been terminated and may not be satisfied with the credit risk of the Authority. The lenders will also resist payments that are spread over a period longer than the residual life of the debt.

How and when to pay compensation?

The Authority should consider the following points:

Cost of payment over time – Deferring termination payments will have a cost for the Authority. Interest will often accrue on the compensation amount from the date the payment is recognised as due until the final payment is effectively made. The Authority will need to agree with the Private Partner and its lenders the interest rate that applies.

Transfer of assets – The lenders may be reluctant to release their security interests on the project assets until compensation payments have been made in full. This may make the transfer of project assets back to the Authority difficult.

Set-off rights – The lenders will in general resist any set-off rights of the Authority, where compensation is debt-based.

4. Authority Default

Authority Default

- Some PPP contracts may broadly define Authority default as “any material breach” which may be subject to various interpretations and ambiguity.

- Advisable to have itemized list of Authority defaults. Some examples:

1) Expropriation or confiscation of assets or shares of the Private Partner

2) Non-payment of sums due to Private Partner (eg: availability fee)

PPP Authority Default

3) Transfer by the Authority of its rights under the PPP contract in violation of the relevant provisions

4) Breach of contractual obligation which frustrates the ability of Private Partner to perform under the PPP contract

5) Failure by the Authority to grant PPP project authorizations

Factors of Consideration

- Always ensure that there is a cure period (i.e. the time available to the Authority to rectify the default, where possible, before right to terminate arises)

- Qualify the itemized list of defaults with materiality threshold

- **Payment default focus** – Private Partner may also be concerned with creditworthiness of an Authority. The Authority may have to provide comfort to the Private Partner (eg: from the Ministry of Finance)

Sample Provision (Termination upon Authority Default)

1. Termination upon Contracting Authority Default, Material Adverse Government Action, Change in Law or public policy

If this PPP Contract is terminated further to (i) a Contracting Authority Default, (ii) a Material Adverse Government Action, (iii) a Change in Law or *[(iv) by the Contracting Authority, for public policy reasons]*[43], the Contracting Authority shall pay the Private Partner an amount equal to the sum of:

(a) The Outstanding Senior Debt; plus

(b) redundancy payments for employees of the Private Partner that have been or will be reasonably incurred by the Private Partner as a direct result of termination of this PPP Contract; plus

(c) any Sub-Contractor Breakage Costs; plus

(d) Initial Equity; plus

(e) any outstanding principal of the Subordinated Finance Documents; plus

(f) [*select from option 1a, 1b, or 1c depending on the required valuation method for the payments due to the equity party*]

- [[**option 1a**] *an amount which, when taken together with any Distributions paid on or before the Termination Date, results in an IRR on the share capital subscribed and amounts advanced to the Private Partner under any Subordinated Finance Document equal to the Base Case Equity IRR*]; *or*

- [[**option 1b**] *the aggregate amount for which the share capital of the Private Partner and the receivables arising under Subordinated Finance Documents could have been sold on an open market basis, under the assumption that there is no default by the Contracting Authority, that no Material Adverse Government Action or Qualifying Change in Law has occurred, that the sale is on a going concern basis and that no restrictions exist on the transfer of the share capital;*[44]] *or*

- [[**option 1c**] *the NPV of forecasted Distributions as at the Termination Date, determined based on the Base Case, using the Base Case Equity IRR*.].

Source: Report on Recommended PPP Contractual Provisions 2015 published by World Bank Group

Compensation for third-party costs

- Factors of consideration for third party costs compensation:

1) **Reviewing the main contracts** – Before signing the PPP contract, review the main contracts the Private Partner has or plans to enter into and assessing the reasonableness of their early termination provisions.

2) **Defining and capping liabilities** – The PPP contract should detail which cost items would be subject to compensation and to what extent. As third-party costs can be significant and fluctuate over time, the Authority may wish to seek to cap its liability in this respect.

Compensation for third-party costs

- Factors of consideration for third party costs compensation:

3) **Compensating for loss of profit** – One of the key commercial issues the Authority will need to address is the extent to which compensation should cover the loss of future profits for the subcontractors.

4) **Catering for redundancy costs** – Careful consideration needs to be given to compensation for redundancy of staff employed by the Private Partner and/or its subcontractors. Also, the Authority should ensure that the Private Partner has an obligation to mitigate costs insofar as possible.

5. Neutral Event Termination

Force Majeure

- Circumstances beyond control of the parties and making it impossible for affected party to fulfil its obligations

- 2 issues:

Extent of compensation during FM	Whether there is termination for prolonged FM

Factors of Consideration

- **Reducing uncertainties** – lenders and investors generally seek protection from all unforeseeable events, with an itemised list with catch-all provisions.

- **Relief and mitigation** – relief should only be granted to the extent obligations cannot be performed and subject to mitigation by affected party.

- **Compensation** – Private party may not receive revenues but still incurs fixed costs. Assessment as to the extent that compensation is provided to share the risks.

- **Prolonged FM** – Parties usually require the opportunity to terminate the contract after a period where it is unlikely that the project circumstances will revert.

Compensation

- The general principle is that financial consequences should be shared because it is neither party's fault.
- Compensation may cover sums owed to the senior lenders (e.g. debt outstanding, unpaid interest, hedging breakage costs), the equity contributions paid in by investors and payments owed to the subcontractors.
- Compensation typically does not cover loss of future income. Monies owed to equity investors are net of distribution amounts already paid out.

Compensation Continued

- Lenders will often not agree to be exposed to financial losses as a result of force majeure termination

- Private partner should not receive equivalent compensation in FM termination compared to Authority Default

Sample Provision (Termination upon neutral events)

3. Termination Upon prolonged Force Majeure Event

If this PPP Contract is terminated further to a Force Majeure Event in accordance with clause [●], the Contracting Authority shall pay the Private Partner an amount equal to the sum of:

(a) The Outstanding Senior Debt, if any; plus

(b) **[●]**% of the Initial Equity and any amounts outstanding under the Subordinated Finance Documents as at the Termination Date; *plus*

(c) redundancy payments for employees of the Private Partner that have been or will be reasonably incurred by the Private Partner as a direct result of termination of this PPP Contract, *plus*

(d) any Sub-Contractor Breakage Costs.

Source: Report on Recommended PPP Contractual Provisions 2015 published by World Bank Group

6. Voluntary Termination

Voluntary Termination

- One of the most important features of a PPP contract is the Authority’s ability to terminate the PPP contract unilaterally (regardless of the Private Partner’s satisfactory performance).

- 2 main approaches that are commonly seen:

Authority has full freedom to terminate the PPP contract	vs.	Authority’s right to terminate the PPP contract is quantified by a “public interest” test

Factors of Consideration

- **Flexibility** –trade-off between the level of flexibility sought by the Authority and the implications that this may have on private sector parties bidding for, financing and operations of the PPP project.

- **Public interest test** – how is the concept of public interest treated on the relevant legal framework and how it can be applied in practice.

- **Fair compensation** – Authority to pay fair compensation to the Private Partner upon voluntary termination.

- **Market confidence** – voluntary termination if exercised too frequently will undermine private sector confidence in the PPP market.

- **Notice period**– Private Partners may require longer notice before termination takes effect.

Compensation for third-party costs

- The general principle of a voluntary termination is that the Private Partner and its subcontractors should not be any worse off or better off as a result of the voluntary termination of the PPP contract.

- Termination payment will normally cover third party breakage costs, demobilisation costs, redundancy costs, senior debt and loss of profits had the contract not been prematurely terminated. Similar to termination payment for Authority Default.

7. Closing Remarks and Q&A

Consequences of Termination

	Private Partner Default		Authority Default		Neutral Event Termination	
	Procurement	PPP	Procurement	PPP	Procurement	PPP
Transfer of ownership over materials and relevant documents, assignment of contracts	✓	✓	✓	✓	✓	✓
Costs for works done up-to-date, third party costs and demobilisation costs	✓	✓	✓	✓	✓	✓
Termination Compensation	None	Senior debt or portion of senior debt (no equity and no loss of profit)	Loss of profits for remaining works and losses incurred in the expectation of completion of the works	Senior debt, initial equity, and loss of profit	Senior debt Sometimes, a portion of initial equity	

Closing Remarks

- Should you terminate?
- Waivers
- Terminate correctly

Questions and Comments?

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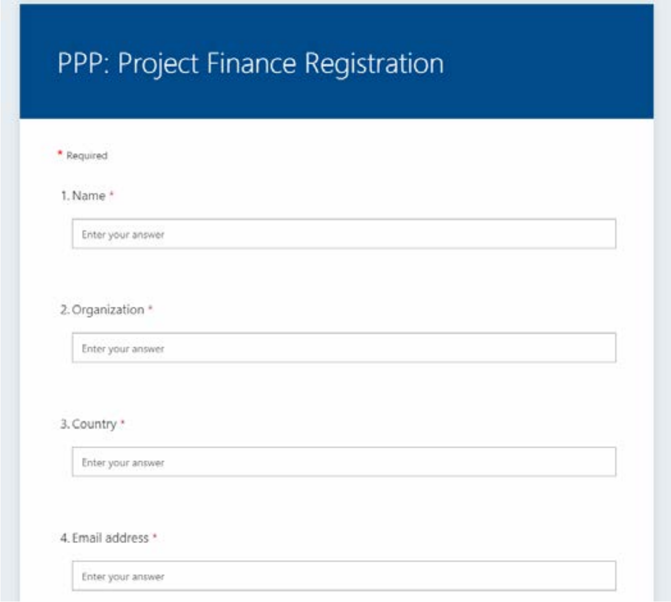

Watch

Tel: +1 202 482 2400

1401 Constitution Avenue, NW, Washington, DC 20230

www.cldp.doc.gov

Lindsey Scannell

Senior Counsel

Asia-Pacific Portfolio

LScannell@doc.gov

Adam Goodman

Attorney-Advisor

Asia-Pacific Portfolio

AGoodman@doc.gov