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New Structures: "Whole Business" Securitizations Of Project Cash Flows

by Denis Petkovic, in London

Capital markets financing is less expensive and more flexible than bank finance. Banks, after all, charge margins on their cost of funds that need to cover capital adequacy costs, return on shareholders' equity, funding costs and profit margins. Banks also need to charge for credit risk and, in the context of project finance, project risk.

If banks, their overheads and costing structures are "disintermediated" and finance is sourced directly from deep and liquid capital markets, competitive funding advantages arise for borrowers able to tap into such markets.

This funding advantage, in part, explains the popularity of securitization as a financing technique.

Securitization is a capital markets tool that enables cash flows to be isolated from the credit risk of the originator. Once isolated from the originator's credit risk, such cash flows can be used to back securities issued in the capital markets — called "asset-backed securities" or "ABS" — having a higher rating than securities issued by the originator! A security with a higher rating than another security will attract relatively lower financing costs.

Borrowers have not been slow to appreciate the competitive funding benefits of securitization. In 1999, global ABS issuance reached $198.8 billion (despite concerns about Y2K and interest rate hikes). Most of the growth in ABS issuance is now taking place outside the United States where ABS issuance increased by 71.2% in

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In Other News

A GROUP OF UTILITIES IS PRESSING CONGRESS TO ALLOW FASTER TAX DEPRECIATION for generating equipment.

The group, organized by the Edison Electric Institute, wants "any property used in the generation of electricity" to be assigned a 10-year "class life" for depreciation. Most gas- and coal-fired power plants are depreciated today over 15 or 20 years, if located in the United States, or 22 or 28 years, if located abroad. The proposal would mean

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1999 over 1998 levels to $47.3 billion.

With this growth has also come another feature: innovative securitization structures have been developed outside the United States, based on local legal concepts, that enable whole businesses rather than isolated receivables to be securitized. These "whole business" securitization structures have particular relevance to international project finance transactions and demonstrate that, increasingly, the demarcation between securitization and project finance is being blurred.

As a result, in Europe, major infrastructure financings are now using securitization, in conjunction with project finance techniques, to enable projects to be financed. An important example of this was the October 1999 issue by London City Airport of £100 million 7.886% senior secured notes due 2021 in order to finance its activities. This transaction was the first time that a "whole business" securitization was used in the context of financing a project in the United Kingdom and provided the issuer with fixed-rate finance for 21 years — terms that the bank debt market simply could not match. (The bank debt market would only look at 3–5 years floating rate finance.)

Given the importance of whole business securitization techniques for project finance, this article examines the background to such transactions generally and the London City Airport transaction in particular.

Basics

Securitization is a process by which illiquid assets, in the nature of cash flows and connected contract rights, are pooled and repackaged into marketable securities representing claims against the illiquid pool. The marketable securities are then sold to third-party investors.

In order to undertake a securitization, it is usually important that the asset pool generates a stable and predictable cash flow because it is that cash flow that will service principal and interest payment obligations under the marketable securities. The illiquid asset pool will also usually provide security for the debt service obligations of the marketable securities. Thus, the pooled assets must be low risk and the loss experience understood.

As with other securities issues, asset-backed securities may take the form of an individual offering where all investors own, pro rata, incoming revenues from the securitized assets or a multi-tranche offering in which different classes or tranches of securities are issued carrying different rights to the asset pool.

Benefits of Securitization

Securitization provides a number of potential benefits over conventional bank finance.

First, it can be a *cheaper and more flexible source of long-term financing*, particularly for companies below investment grade. This was a major reason driving the London City Airport transaction where the term of the notes issued was far longer than that available in the bank debt market. Also in the case of whole business securitizations, interest coverage ratios, debt-service-coverage ratios, debt-to-equity ratios and debt-to-earnings ratios are perceived to be more generous than in the case of bank-financed deals. Moreover, other perceived benefits arise over bank finance for issuers. In a default scenario, troublesome bank group dissenters are less likely to be prevalent as they will have been replaced by bondholders. Bond trustees are also less influenced by relationship factors than an agent bank on a bank deal.

Second, securitization can provide *balance-sheet relief* through the removal of securitized assets and corresponding funding liabilities from the balance sheet of the originator (thereby improving capital adequacy ratios in particular for financial institutions and reporting ratios, such as debt-to-equity ratios and return-on-assets ratios).

Third, it is a method for widening a company's sources of finance thus *enhancing liquidity*.

Fourth, it enables *assets* to be *matched with liabilities*. A 20-year income stream may be financed by bonds having a 20-year term thereby avoiding risks of funding mismatches.

Securitization is considered to be "good for business" by compelling an issuer to be more disciplined in how it operates its businesses thereby improving systems, documentation and the issuer's understanding of the real cost of its portfolio. It is also becoming more familiar to regulators outside the United States. The introduction of securitization-friendly laws in markets such as Italy and France has caused corporates and regulators to embrace securitization to such an extent that it is no longer viewed in such markets with suspicion but rather as an important and necessary finance technique.

"True Sale" Securitizations

The most common type of securitizations are receivables sales or "true sale" securitizations.

These involve the transfer of assets by the originator to a bankruptcy-remote special-purpose vehicle that issues debt to fund the purchase. The receivables invariably continue to be administered or collected by the originator with little real disturbance to existing collection procedures.

A "true sale" structure does not easily accommodate originators with contracts that are difficult to transfer, businesses that have numerous bespoke contracts generating receivables, businesses that generate cash revenues or businesses that require much time and management to generate revenues. For such originators — and London City Airport was one of them — the use of "whole business" securitizations is more appropriate.

General Issues

Whatever structure is adopted for a particular

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such power plants could be depreciated over seven years in the United States or 10 years overseas. It would spark a major revival in equipment leasing.

Rep. Bill Archer (R.-Texas), chairman of the House tax-writing committee, told committee republicans in a closed-door meeting in June that one of his priorities is to pass legislation this summer to update depreciation allowances.

High-tech companies have apparently already been promised faster depreciation for their assets. The utilities are playing catchup. They have hired Washington lobbyist Ken Kies, who used to work for Archer.

INDIA increased the effective tax rate on earnings from Indian projects from 45.27% to 52.03%.

FIVE MAURITIUS COMPANIES received notices from the Indian tax authorities in March asserting the companies do not qualify for benefits under the India-Mauritius tax treaty. The notices attempted to collect taxes back to 1996. However, India quickly withdrew them after the Bombay stock exchange index dropped 200 points when news of the notices broke on April 4.

Meanwhile, a public interest lawsuit has been filed in the Delhi high court claiming that the Indian government withdrew the notices under pressure from the finance minister, whose daughter-in-law manages India Fund Inc., a Mauritius-based fund that invests in Indian companies. The daughter-in-law works for Oppenheimer Investment Advisers in New York.

BULGARIA unilaterally revoked its tax treaty with Cyprus after discovering that most investment into Bulgaria was being run through Cyprus to avoid withholding taxes.

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securitization transaction, a range of issues must be considered in nearly all cases.

One issue is the benefits sought to be achieved by the originator of the asset pool and how to structure the deal to achieve them.

Another issue is the nature of the asset pool to be securitized. In this regard, the term and regularity of payment of the asset pool will be a deal driver as will the credit quality of the pool. Almost all securitizations require credit "enhancement" to cover the risk of underlying obligors in the pool defaulting. Typical credit enhancement alternatives include injecting "extra" financial assets into the securitization — such as additional receivables — and using reserve accounts and credit wraps (such as insurance and letters of credit from third parties). Administration and collection of the pool must also be considered, in particular, to minimize the risk of co-mingling of assets of the administrator and the pool.

Another issue is asset isolation. The structure selected must be able to withstand the bankruptcy of the originator. In the United States, too much recourse back to the seller and too little default risk being transferred to the buyer may undermine the assets being considered as transferred to the buyer with there being no resulting "true sale." Under English law, legal form is more generally respected.

In addition, observance of all legal formalities associated with any transfer of underlying assets must take place; otherwise, the assets may not vest in the purchaser. In English "true sale" securitizations, for example, equitable assignments of assets are common under which written offers and oral acceptances typically effect a transfer so as to avoid local stamp duty. This type of transfer has other legal consequences — for example, by virtue of s.136 Law of Property Act 1925, the purchasers under such an assignment cannot enforce the assigned debt directly against the debtor in legal proceedings without first joining the seller. (This would not be the case if notice of the assignment were given to the debtor by the seller — a perfected "legal" assignment.) Other methods of asset transfer used in the UK in the context of securitizations include using participations and, increasingly, declarations of trust. Compliance with applicable accounting rules is necessary if off-balance sheet treatment is required.

Another issue is how best to effect credit and liquidity enhancement. "Credit enhancement" addresses the risk of nonpayment by obligors while "liquidity enhancement" addresses risk of payment at the wrong time.

Credit enhancement is usually provided by the seller, rather than a third party, and usually through reserves of assets rather than direct recourse. As the pool liquidates and pays out the lenders, the remaining reserves vest in the seller. Another popular technique is for the seller to buy a junior tranche of marketable securities subordinate to the securities issued to the purchaser.

Direct or third-party liquidity enhancement is common in the form of loans, the structure of which will be settled having regard to capital adequacy considerations of the lender.

Tax issues are major concerns. There may be stamp duty, value-added tax, and withholding tax to pay, especially after transfer of assets to the purchaser and on any marketable securities issued under the securitization.

Finally, there will probably be regulation specific to the industry of the originator that will have an effect on the transaction structure.

Public or Private Offering?

If the marketable securities are to be offered to the public, then terms and conventions commonly used in the market must apply, including the need for the securities to be rated. Private offerings, on the other hand, may contain customized or unusual terms. Where securities are to be rated,

they are unlikely to be rated higher than the seller's rating in the absence of substantial elimination of seller credit risk. Legal issues to be considered include compliance with securities laws and laws governing conduct of investment activities.

Ratings

ABS investors are usually institutional investors, such as pension funds, who lack the resources to evaluate ABS risks. Such investors rely on rating agencies to do this for them. The rating agencies do so after focusing on the quality of the pooled assets and key factors such as asset isolation and credit and liquidity enhancement before ascribing a rating to a deal.

In order to rate a whole business securitization, rating agencies have adopted an approach that combines elements of a structured or securitization transaction and a corporate transaction. For example, Standard & Poor's focuses on four key concerns.

1. *Status of originator*. If it is sought to rate an issue above the originator's rating, then the key operating company should ideally be a single-business and single-activity company so that the scope of the commercial risks associated with the business can be determined. This part of the rating agency analysis derives from a corporate bond issue ratings approach. The concentration is on future revenues and understanding the cash-generating attributes of the relevant business. There is no fixed portfolio of assets being securitized (as would be the case in a true sale securitization) and, consequently, the rating agencies must obtain an understanding of business operating risks, competitive risks and costs and revenues.

2. *Enforceability*. The transaction must be enforceable and not subject to legal challenge. While general law grounds — like *ultra vires* and capacity — for a challenge must be considered, insolvency law impact is the key concern as it

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In Other News *cont.*

TAX LAWYERS DISCUSSED STRATEGIES FOR STRIPPING FOREIGN TAX CREDITS at the American Bar Association meeting in May. The IRS said it is starting to see at least one of the strategies show up on audit.

"Stripping" foreign tax credits refers to the idea of bringing back credits for use in the United States before the earnings become subject to US tax. The IRS said two years ago in Notice 98-5 that it is considering requiring that use of foreign tax credits wait until the earnings become taxable in the US. However, it has been slow to act.

In one structure, a US company owns a foreign subsidiary, FC1, which owns FC2. FC2 owns the project. FC1 is transparent for US tax purposes, but it is treated as a corporation by the foreign country. FC2 is a corporation in the US, but transparent abroad. Therefore, the foreign country views its taxes as imposed on FC1. However, because FC1 is transparent for US tax purposes, the US treats the taxes as imposed on the US parent while the earnings from the project remain insulated from US taxes because they are in FC2.

In another structure, FC1 and FC2 are both corporations for US tax purposes. However, the foreign country views FC1 as a corporation and FC2 as transparent. Therefore, foreign taxes are imposed on FC1. Earnings remain trapped for US purposes in FC2. A small dividend by FC1 to the US releases all the foreign tax credits for use in the United States.

IRS INDECISION COULD MAKE IT MORE EXPENSIVE TO INTERCONNECT MERCHANT PLANTS to utility grids.

The IRS has adopted a "no ruling" position on the tax treatment of electrical interties in merchant plants. Ordinarily, when an independent power producer connects to a utility grid, the utility insists on taking title to the intertie but makes the power producer pay the cost. The IRS said in a 1988 notice

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would be on a conventional structured deal or receivables financing.

3. *"True" control*. The issuer must have total control over the underlying security package and revenues. The security package should confer priority over all other creditors and, once realized, the proceeds of the security package should repay all indebtedness under the notes.

In terms of the "control" issue, under English law, a first ranking fixed charge will largely be unaffected by liquidation. Administration is another issue. This is a procedure under which a creditor or director can petition the courts to appoint a licensed insolvency practitioner as "administrator" of a company if to do so would achieve a better realization of the transferor's assets than would be achieved on a liquidation or the survival of the company as a going concern.

An automatic stay on security enforcement can apply on the appointment of an administrator, and the administrator can dispose of assets charged to other creditors whether under fixed or floating charges. Standard & Poor's says:

> "The balance of control in administration is weighted against the secured creditor. If the originator is in administration, there can be no true control."

A secured creditor can appoint an administrative receiver and block the appointment of an administrator provided that the security package contains a floating charge over the whole or substantially the whole of the property, assets and undertaking, present and future of the applicable company.

At a minimum, rating agencies require floating charges to be included in the security package for a "whole business" securitization. In addition, first priority security interests must be granted over the assets of the operating company which should secure, in full, the principal and interest on the ABS. Certainly floating charge assets should not primarily be relied upon to generate funds to pay investors.

4. *Liquidity support and other structural considerations*. As with a conventional true sale securitization, liquidity support via cash reserves and liquidity facilities is typically considered at a level that mitigates liquidity risk. In addition, structural requirements (such as credit enhancement and measures to reduce the risk of challenges to security arrangements and potential insolvency filings against key companies) are also focused upon. The importance of credit enhancement cannot be underestimated. Many whole business deals are real-estate based with overcollateralization provided through the excess of the value of real estate over the secured indebtedness.

Conclusions

"Whole business" securitizations offer a potential solution to the difficulty of structuring around underlying revenue streams arising from contracts that are not assignable or capable of being subject to fixed security and complex businesses that require active management and that generate revenues otherwise than from short-term receivables. Such transactions will increasingly be a feature of international securitizations, particularly in markets where creditor-friendly bankruptcy laws allow creditors, effectively via receivers, to assume control of underlying revenues on an on-going basis and manage the revenue pool of a business in order to extinguish capital markets indebtedness.

To date, the whole business securitization technique has been mainly used as an important *refinancing* tool — primarily for acquisition financings.

However, such a structure may be used to finance the construction or development phase of a project if a third-party credit wrap from an insurer or other rated entity is obtained or if one has "free" unencumbered assets from existing projects for use as over-collateralization.

Whole business securitization can also be adapted to accommodate international companies with assets in various countries some of which do not permit direct security. In a recent transaction, key operating companies of the Tussaud Group granted mortgages over the shares of companies located in markets where direct security was not possible together with covenants to ensure that such "downstream" companies did not incur debts or grant security over or dispose of their assets. A satisfactory rating was nevertheless forthcoming.

More adaptations of the whole business securitization structure will certainly follow as the pace of international securitization increases and as originators in securitizable industries or sectors come to recognize the need to finance their businesses through the capital markets to ensure they are not at a competitive disadvantage. ■

London City Airport Transaction

The London City Airport financing last fall was the first use of "whole business" securitization to finance a project in the United Kingdom. The transaction structure is shown on the next page.

Background

London City Airport opened in 1987 and operates as a premium city center airport for business travelers between London and other European city centers. The airport is operated by London City Airport Limited. In October 1995, the company came under the control of Irish businessman Dermot Desmond. Since that acquisition, the airport has experienced substantial growth becoming the seventh largest airport in the United Kingdom with 11 airlines operating scheduled routes to 23 European destinations. In 1998, the airport was granted planning consent to expand its plane movements by approximately 100% over 1998 approved levels.

London City Airport's revenues are generated from aviation activities (72%) and commercial activities (28%). Aviation revenues are derived from the movement of aircraft passengers and cargo through the airport. The commercial income of the airport has traditionally consisted of duty-free sales, concessions, property rental income, ticketing and check-in desks and other non-core businesses associated with the operation of the airport. Additional revenues have also been generated from the provision of transportation to and from Liverpool Street station and Canary Wharf.

Deal Structure

Funding — An issuer was formed in the Cayman Islands to issue £100 million in 7.886% secured notes due 2021 to investors. The notes were rated Baa2 by Moody's, BBB by Standard & Poor's and BBB+ by Fitch.

The issuer lent the proceeds from the notes to its wholly-owned subsidiary, London City Airport Limited, which operates the airport. This term loan was on substantially the same economic terms as the notes. The term loan was made under a loan agreement containing covenants typically found in corporate loans. The fact that the issuer and London City Airport are within the same group indicates that the prime motive for the deal was to raise attractive long-term finance via the capital markets rather than to achieve off-balance-sheet financing.

London City Airport Limited owns certain leasehold interests that comprise the airport. It holds those interests under a sublease from a UK company — called "Airport Holdco" in the chart — that is the

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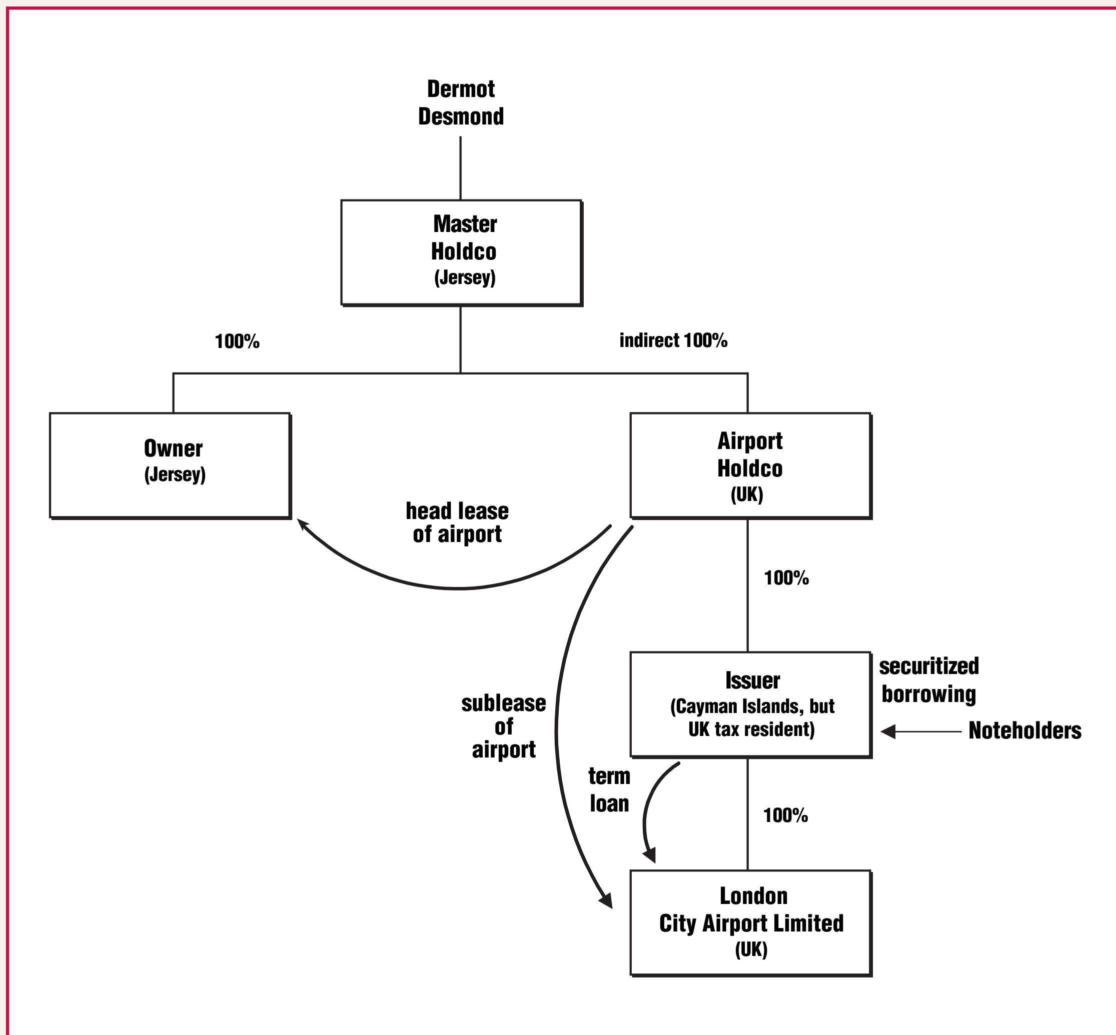
parent of the issuer. Airport Holdco holds its interest in the property comprising the airport pursuant to a head lease from a Jersey company — called "Owner" in the chart — that is the ultimate owner of the property. All these key companies are ultimately controlled by Dermot Desmond through a common holding company incorporated in Jersey — called "Master Holdco" in the chart.

Security — The term loan agreement required London City Airport to grant a deed of fixed and floating charge over all its assets. The security was granted in favor of a security trustee. The security package includes a first priority security over all of London City Airport's assets.

The documents subordinate rental payments by London City Airport to Airport Holdco to debt service payments on the notes issued by the issuer.

The issuer, in turn, granted to the security trustee for the noteholders, as security for the issuer's obligations under the notes, first priority security over all its assets, including all its rights under the transaction documents, bank accounts and the issuer's shares in London City Airport Limited.

Security arrangements are the cornerstone of "whole business" securitizations. Under English insolvency law, the security trustee may, on default by the



London City Airport Transaction

issuer or London City Airport, appoint an administrative receiver over the assets of chargor companies. The receiver can continue to manage the businesses of such companies, collect revenues and repay capital markets indebtedness without the need for a disruptive asset sale by virtue of a default by a chargor company. In this sense, there is an analogy between "whole business" and conventional "true sale" securitizations: the underlying income-generating assets are capable of being controlled by the issuer's creditors, notwithstanding default or insolvency of the issuer.

One unusual feature not commonly present in "true sale" securitizations is found in whole business securitizations: where a group company gives security for the benefit of a group company — Airport Holdco and Owner each granted, among other things, first ranking floating charges over all their property and assets and undertakings in favor of the security trustee — then section 245 of the Insolvency Act 1986 should be noted. This provides that a floating charge in favor of a connected person will be invalid within two years of the onset of insolvency, except to the extent of any value given on or after the creation of the charge by the chargee. Such invalidity risk was present in the London City Airport deal because the charges from Airport Holdco and Owner granted to the security trustee were done so by the trustee on behalf *of the issuer*. As these companies were connected to the issuer and neither received any consideration from the issuer, there was a risk that their floating charges would be invalid.

If the floating charges were subsequently enforced and deemed invalid, then the remaining security granted by Airport Holdco and Owner would still be valid (being the first ranking fixed security granted over their respective leasehold and freehold interests in the airport). However, under English law, it would not be possible for the security trustee to block the appointment of an administrator to Airport Holdco or Owner who could theoretically deal with the assets that are the subject of the fixed security in favor of the security trustee under the Insolvency Act, notwithstanding the trustee's security interest.

In this transaction, the section 245 invalidity risk was overcome through contractual covenants under which Airport Holdco and Owner covenanted not to engage in any activity that is not incidental to owning its interest in the airport, have employees or premises other than the airport (save as permitted under the documentation), or incur financial indebtedness or make guarantees. These entities were, in substance, converted into special-purpose vehicles by virtue of covenant restrictions.

As a consequence, it was considered unlikely by the rating agencies that an administration order would be made because an order may only be made if its purpose is for the survival of the relevant company as a going concern, or on the basis that administration would achieve a better realization of assets than would a winding-up. If the companies were one-asset companies with no real "going concern" business, then this test was not likely to be met and, in any event, even if an administrator were appointed, it was considered that the court would permit the security trustee to enforce its security over the real property interests mortgaged to it.

Credit enhancement — Credit enhancement was provided for in the securitization in two ways. First, London City Airport Limited deposited £5 million from the term loan into a cash reserve account for application against amounts due to the issuer under the term in order to remedy any breach of financial covenants. Second, there was over collateralization represented by the market value of the airport — appraised to be £165 million — relative to the amount of the term loan.

Liquidity enhancement — Liquidity enhancement had to be provided by a bank having a particular rating for its debt. Allied Irish Banks, plc agreed to lend £7 million to the issuer to meet the issuer's payment

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obligations falling due on each interest payment date under the notes to the extent that the issuer received insufficient funds from London City Airport under the term loan. As is common with liquidity facilities, the term was 364 days renewable annually.

In addition, London City Airport was granted by Allied Irish Banks, plc a revolving credit facility in a maximum principal amount of £7 million for its general corporate purposes for a term of seven years. The additional facility is a working capital facility intended to ensure that third-party creditors are not able to petition London City Airport into a voluntary winding up.

Revenue administration — As with true sale securitizations, the administration of the revenues of the operating business is left with the key operating company to avoid business disruption. Thus, London City Airport Limited is required to act as "cash manager" under a cash management agreement and provide to the issuer and the security trustee notification and reporting services and cash management services in relation to monies standing from time to time in the issuer's bank accounts. A bank account agreement was also entered into among London City Airport Limited, the bank and the security trustee regulating the manner in which London City Airport was to operate its bank accounts.

Unusual Feature

An unusual feature of the security arrangements in this transaction was that London City Airport did not grant any fixed security interest over its material contracts generating revenue in excess of £100,000 per annum. This is because some of the material contracts were non-assignable without the consent of the other contracting parties and, in any event, many of the contracts could terminate at any time. However, a fixed charge over all receivables payable under such contracts was sought to be taken by the security trustee. Covenants were imposed on London City Airport Limited to ensure that future material contracts did not contain a prohibition on charging unless to do so could reasonably be expected to have a material adverse effect on London City Airport.

Business Risks

The rating agencies considered a number of business risks before granting their rating.

Permits — London City Airport's operating license from the Civil Aviation Authority, whose issuance and renewal was based mainly on considerations of safety, was considered together with planning consents — relating to noise, air quality, transport and landscaping — and rules pertaining to regulation of airport fees and charges.

Recent regulations — As the airport was mainly a business travelers' airport, revenue derived from lost duty-free sales as a result of recent European Union regulations was not considered to be significant. The European "Ground Handling Directive," which requires airports with large passenger volumes to subject their baggage handling services to competitive tender, was considered not to have a material adverse effect on London City Airport's ability to meet its obligations under the term loan.

Airline industry risks — The business travelers' focus of the airport supported the conclusion that revenues for the airport were likely to remain strong even if general economic conditions deteriorated or there was a downturn in the airline industry or if low-cost carriers continued to have success in attracting largely non-business passengers. It was noted also by the rating agencies that transport links for the airport are currently being improved which would also make it more convenient for business travelers to reach the airport.

Increased competition from other airports in the southeast of England was considered by the rating agencies, although this was thought unlikely to have a material adverse effect on London City Airport. Likewise, capacity constraints at some larger European destinations may affect decisions by airlines using London City Airport to maintain or grow existing

London City Airport Transaction

services provided by regional jets or turboprop aircraft (which operate from London City Airport owing to the size of its runway and other technical factors).

Aircraft accident risk was also considered. The agencies noted that the airport adheres to Civil Aviation Administration standards in the UK, and the airport has not only a very good operational safety record but also a comprehensive insurance program (including business disruption insurance).

Contracts used by airlines operating at London City Airport can be terminated on immediate notice without additional liability. While any termination could have a material adverse effect on the airport, particularly if significant airlines or routes are affected, history indicates that the effects of any such termination may be mitigated over time by replacement airlines or routes. The risk of termination is mitigated by two considerations. First, if an airline wanted to move to another London airport, it would face capacity constraints. Second, the cost of an incumbent airline switching airports may be high.

Environmental risks — The rating agencies also investigated possible environmental concerns, including potential areas of subsurface contamination. However, site consultants concluded that such risks remained low in this instance. London City Airport Limited had to make representations and warranties about compliance with environmental laws. Title to the airport was investigated and the property was valued at £165 million. It was noted that the airport is a highly specialized asset for which there is not a ready market in a default scenario. London City Airport is required to maintain insurance on the airport at replacement value naming the security trustee as a co-insured. Reports covering insurance, environmental issues and valuation issues were called for by the security trustee. ■

— Denis Petkovic, in London

US Congress Edges Closer To Action Against Aggressive Tax Schemes

By Keith Martin, in Washington

The US Congress is edging closer to action against corporations that engage in aggressive tax planning. The Senate Finance Committee released a draft bill for comment in late May. The bill is expected to pass the Senate this summer. Its future is less certain in the House.

40% Penalty

Under the bill, corporations that have tax benefits from a "corporate tax shelter" disallowed will be hit with a 40% penalty.

The bill defines "corporate tax shelter" broadly as any transaction where a tax-shelter indicator is present. The indicators are as follows:

- The expected pre-tax profit from the transaction is insignificant in relation to the expected tax benefits. This is true of most affordable housing deals and alternative fuels projects that qualify for section 29 tax credits.
- The transaction is with a "tax-indifferent party" and this produces a benefit for the US participant. An example may be a leasing transaction between a US equity and a foreign lessee. The benefits that would trigger this indicator are a shifting of more taxable income than economic income to the tax-indifferent party, or the ability of the US participant — because the transaction involves a tax-indifferent party — either to characterize its tax position more favorably than it would otherwise or to claim a "non-economic" stepup in asset basis.
- The taxpayer has a "tax indemnity or similar arrangement" to ensure it gets the tax

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Action Against Tax Schemes

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benefits from the transaction. However, a "customary indemnity in an acquisition" does not count if the indemnity is given by a party with a "meaningful economic interest" in the transaction.

- The taxpayer has little economic risk.
- The transaction will produce a "permanent" book-tax difference in how any income is reported.

The last three indicators only apply in transactions where the expected net tax benefits are significant. The bill implies that net tax benefits with a present value of at least $5 million are significant. It specifies the discount rate to be used for present value calculations: the federal short-term rate plus 1%.

Penalty Shifts to Advisers

A corporation could reduce or eliminate the penalty by getting a tax opinion and disclosing the details of the transaction to the Internal Revenue Service, but only where it has a material nontax business purpose for the transaction. The chief financial officer "or other senior corporate officer with knowledge of the facts" would have to sign a perjury statement attesting to the accuracy of the disclosure. The penalty would then shift to the tax adviser writing the opinion. However, in his case, he would be exposed to a penalty for half his fees.

The tax opinion would have to be at least a "should" opinion to avoid penalties. (A "more-likely-than-not" opinion from the tax adviser would reduce the potential penalty to 20%, but not eliminate it. There would be no shift in that case of penalties to the tax adviser.)

The bill goes into some detail about when a corporation would be able to rely on the tax opinion. The opinion would have to be "long form." In other words, it would have to recite all the material facts of the transaction. The adviser would have to inquire into whether there is a material nontax business purpose; he could not unreasonably assume it. The opinion must do a thorough job of identifying and considering all the relevant judicial doctrines. This will tend to drive the job of opinion writing to the better firms; the taxpayer runs the risk of not being able to rely on it if the opinion is not thorough. The opinion cannot come from the tax shelter promoter. The tax adviser writing it cannot be paid by the promoter. His fee cannot be contingent on the tax benefits.

Tax advisers who give "should" opinions run the risk of being penalized for half their fees from the transaction if the tax benefits are disallowed. All persons who assist with "creation, organization, sale, implementation, management or reporting" of a corporate tax shelter also run the risk of the same penalty.

Tax advisers who give "should" opinions run the risk of being penalized for half their fees from the transaction if the tax benefits are disallowed.

The IRS will publish the names of persons who are penalized in connection with corporate tax shelters.

In addition, the corporation would have to send a notice to let its shareholders know that it has been penalized for participating in a corporate tax shelter. This would be required for penalties of at least $1 million.

Outlook

There is a growing consensus in Washington that Congress must take action to prevent corporations from adopting aggressive tax schemes. The staff of the Congressional Joint Committee on Taxation released a set of recommendations last

summer. The chairman and ranking democrat on the Senate tax-writing committee — Senators William Roth (R.-Del.) and Daniel Patrick Moynihan (D.-N.Y.) — released the draft bill described in this article in late May for public comment. The bill is now being reworked to reflect comments. (Comments were due on June 9.) Roth has said he plans to put it through the Senate this summer. The main opponent to action by the House is the chairman of the House tax-writing committee, Rep. Bill Archer (R.-Texas). Archer retires at the end of this year. ■

OECD Publishes Blacklist Of Tax Havens

by Keith Martin, in Washington

The Organization for Economic Cooperation and Development, or OECD, published a list of 35 tax havens at the end of June. Companies that invest through these tax havens risk sanctions starting in August 2001.

The list includes the following countries:

- Bahamas
- Belize
- British Virgin Islands
- Jersey
- Netherlands Antilles
- Panama

Noticeably absent from the list are the following jurisdictions used frequently by the project finance community: Cayman Islands, Bermuda, Mauritius, Cyprus, the Netherlands and Luxembourg. All except the Netherlands and Luxembourg were excluded from the list after they committed to the OECD that they would take steps to eliminate harmful tax practices by the end of 2005. The Netherlands and Luxembourg did not meet the criteria for tax havens.

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that the utility does not ordinarily have to report the value of the intertie as income, at least when the intertie is tied to a "qualifying facility" project under the Public Utility Regulatory Policies Act, or PURPA. The IRS extended the same rule to other independent power projects by private ruling. If the utility had to report the value as income, then it would insist that the power producer pay not only the cost of the intertie, but also a tax "gross up" that can add roughly another 50% to the cost of interconnection.

Recently, two utilities asked the IRS for rulings about interties in merchant plants. The IRS said it is no longer prepared to rule in such cases until it has a better understanding of all the fact patterns that might come out of deregulation.

Discussions are underway with the Treasury Department.

HOLLAND announced that it will no longer issue tax rulings on hybrid instruments or entities.

A hybrid is an instrument or entity that is characterized one way for tax purposes in Holland and a different way for tax purposes in another country. For example, an instrument through which a Dutch holding company injects money into a project company in Turkey might be classified as debt for tax purposes in Turkey, but as equity in Holland. This would enable the owners to "strip" earnings by withdrawing them from Turkey in a deductible form (interest), but to avoid tax on the earnings in Holland since they are viewed in Holland as an equity return (dividends). Earnings coming into Holland as an equity return are usually exempted from Dutch taxes under a "participation exemption."

Dutch transactions are usually done with advance rulings from the tax authorities. It remains to be seen whether companies will be willing to act in future merely on the basis of legal opinions.

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The Cayman Islands escaped the listing by pledging to begin sharing criminal tax information with OECD countries after 2003 and to share civil tax information after 2005.

The OECD is an organization of developed countries based in Paris. The United States and Canada, along with European countries, Australia, New Zealand and Japan, are members.

Sanctions have been delayed for a year to give the tax havens a chance to cooperate. The OECD will publish a list of "uncooperative tax havens" in July 2001. Tax havens can escape being included on this list by pledging to share tax information. The OECD will work in the meantime to come up with a list of sanctions it recommends that OECD member countries take against companies investing through uncooperative tax havens. These will probably include denial of US tax deferral (in the case of US companies) and foreign tax credits. Countries from whom earnings are distributed to tax havens will probably also increase withholding taxes on such earnings.

The sanctions will require action by individual member countries. The Clinton administration proposed a set of sanctions similar to the OECD list to Congress in the budget this year, but Congress looks unlikely this year to take any action.

The OECD report also lists tax benefits in developed countries that it believes promote harmful tax competition. The only US item on this list is foreign sales corporations, or FSCs. None of the items listed for other countries is widely used in the project finance community. OECD countries have committed to eliminate the harmful tax practices by April 2003.

The OECD said it was not tackling holding company regimes in such places as Denmark, Ireland, Holland and Luxembourg in this report, but expects to report further on them by early 2001. ■

A Better Cayman?

by Heléna Klumpp, in Washington and Waldo Kapoen and Marc Klerks, of Loyens & Loeff, in The Hague

Recent changes in law should revive interest in the Netherlands Antilles as a place to put offshore holding companies. The Netherlands Antilles are a group of islands in the Caribbean: Curaçao, Sint Maarten, Saba, Bonaire and St. Eustatius.

Most US companies investing in infrastructure projects outside the United States try to structure the investments so that US taxes can be deferred on earnings so long as the earnings are retained offshore. This requires investing through an offshore holding company. The Cayman Islands are currently the most popular jurisdiction for such holding companies, although Bermuda, the British Virgin Islands and Holland also are used frequently.

Perhaps later this year — if the Netherlands Antilles are able to qualify for direct benefits under the wide Dutch treaty network with other countries — the Dutch Antilles might eclipse the Cayman Islands as the jurisdiction of choice.

Companies that invest through Holland usually do so in order to take advantage of the wide network of tax treaties that Holland maintains with other countries. However, the problem

with Holland is there is usually a withholding tax at the Dutch border to repatriate earnings eventually to the United States, and the Netherlands collect a 1% capital tax on equity contributions run through a Dutch holding company.

The Netherlands Antilles amended their own laws effective last January and have been in negotiations with Holland this year in order to attract more holding company business. The net effect of the changes thus far is that any company planning already to invest through Holland should use a two-tier holding company structure — Dutch Antilles on top and Holland below. This will reduce the withholding tax to repatriate earnings eventually to the United States.

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Ancien Regime

Previously, certain offshore holding companies incorporated in the Netherlands Antilles were subject to tax at a very low rate — sometimes as low as 3%. The new legislation abolished this offshore company regime as of January 1, 2000. Instead, all Dutch Antilles companies are now subject to a 34.5% profit tax. A grandfather rule provides that offshore companies existing on December 31, 1999 will be taxed at their pre-2000 rate through 2009 or 2019, depending on the type of activities in which the offshore company is engaged.

In place of the offshore company regime, the new legislation created a new type of company that is exempt from all profits tax and dividend withholding tax, an "exempt company." Any Netherlands Antilles private limited company can qualify, but it may only engage in certain very limited activities (holding and financial). These companies will not be entitled to any benefits

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SAUDI ARABIA cut taxes on foreign investors, but details of the reforms have been slow to emerge. The reforms may not be as generous as first thought.

Saudi companies have been subject to income tax at rates up to 45%, but only to the extent the earnings belong to foreign shareholders. Business profits accruing to Saudi nationals are subject solely to a religious wealth levy, or zakat. Most industrial projects qualified for tax holidays of up to 10 years. Tax losses could not be carried forward.

The government said recently it planned to reduce the corporate tax rate to 30% and to allow losses to be carried forward until fully absorbed. However, it now appears any tax rate reduction will be in the form of rebates. No details have been released about the timing or procedure for claiming rebates. Tax holidays have been abolished. Existing holidays will reportedly be allowed to be carried to full term. Companies will be allowed to carry losses forward, although this may be subject to conditions. Until the details are published, they remain subject to further change.

SECTION 29 TAX CREDITS were adjusted downward April 1 after the US government revamped its inflation index. The section 29 credit is a credit for investing in alternative fuels projects. The credit went from $1.052 an mmBtu of fuel produced in 1998 to $1.035 an mmBtu for fuel produced in 1999.

BIOMASS GROUPS are lining up behind a bill that Senators Trent Lott (R.-Miss.) and Frank Murkowski (R.-Alaska) introduced in the Senate in May to let section 45 tax credits be claimed on electricity generated from biomass.

Section 45 credits are credits of 1.7 cents a kilowatt hour for generating electricity from certain types of fuel. The only fuels that qualify currently are wind, poultry waste and "closed-loop biomass,"

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under Dutch tax treaties with other countries.

The substitution of the blanket profits tax and the limited exempt company for the popular offshore holding company seems at first glance to be a negative step for residents of the Netherlands Antilles. However, looking forward, this move was designed to create much greater flexibility for Netherlands Antilles taxpayers. By restructuring its tax regime the Netherlands Antilles hope to become a party to a number of bilateral tax treaties to which the Netherlands is a party and to bring itself in a position to negotiate its own tax treaties directly with third countries. (Currently, aside from a treaty with the Netherlands and Aruba, the Netherlands Antilles are party to only one tax treaty, with Norway.)

The Dutch treaties upon which the Netherlands Antilles are hoping to capitalize contain a provision entitled "territorial extension." Taken from the Netherlands-Canada treaty, that provision says that "This Convention may be extended ... to the Netherlands Antilles or Aruba, if those countries impose taxes substantially similar in character to those" in Holland or the other treaty partner. Abolishing the offshore holding company regime and imposing a blanket tax on all taxpayers was designed to meet this standard. Examples of treaties containing such language are Canada, Venezuela, India and Mexico, along with a number of European countries.

Participation Exemption

A key feature of the new law is a participation exemption. Dividends and capital gains one Netherlands Antilles company derives from "qualifying shareholdings" in another Netherlands Antilles company are now completely tax-exempt to the recipient. If the payor is a non-resident company, dividends and capital gains are 95% tax-exempt. The exemption only applies if the recipient owns at least 5%, by vote or value, of the distributing company.

Withholding Taxes

A new 10% withholding tax applies to dividends distributed out of the Netherlands Antilles. However, exceptions apply. A liquidating distribution is not subject to dividend withholding tax. Dividends distributed by a company that is listed on a qualifying stock exchange — for example, NYSE, London, Frankfurt — and distributions by a Netherlands Antilles company that is, directly or indirectly, owned by a qualified listed company are not subject to dividend withholding tax. Furthermore, distributions made to any nonresident shareholder that has owned 25% of the payor's outstanding shares (by vote or value) for at least one year are exempted from dividend withholding tax.

Under certain circumstances, an additional profits tax levy at a maximum rate of 5% may apply with respect to liquidating distributions or distributions to or by companies that are listed on a qualified stock exchange.

Tax Treaty with Holland

Negotiations are underway to amend an existing tax treaty among the Netherlands Antilles, Aruba and the Netherlands to provide that no withholding tax will apply to dividends paid by a Netherlands company to a shareholder in the Netherlands Antilles. The exemption would only apply if the recipient owns 25% or more of the payor. These negotiations are expected to be finalized in mid-2000. The negotiations are expected to be concluded later this year.

A word of caution — although the new legislation took effect on January 1st of this year, it is not yet set in stone. The Netherlands may require the Netherlands Antilles to make a few changes to the law as part of the negotiations for the withholding tax exemption.

Wild Card

The one wild card in the equation is the Nether-

lands Antilles appear on a "blacklist" of tax havens that the Organization for Economic Cooperation and Development, or OECD, released at the end of June. Companies investing through listed tax havens risk sanctions starting a year from now (assuming OECD members take action to implement such sanctions). The Cayman Islands are not on the list of tax havens. The Netherlands Antilles can escape the list by taking the same steps — to which the Cayman Islands have committed — to share tax information and subject banking transactions to greater scrutiny. ■

Companies Hoping To Tap Into US Capital Markets Must Comply With Trade Sanctions

By Samuel R. Kwon, in Washington

Foreign companies may be unable to raise debt or equity in the US capital markets if they have violated US trade sanctions against third countries.

The United States imposes trade embargoes against 11 countries. The 11 are

Afghanistan
Angola
Burma (Myanmar)
Cuba
Iran
Iraq
Libya
North Korea
Sudan
Syria
Yugoslavia (including Serbian-held regions of Bosnia and Herzogovina)

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or plants grown specifically to be burned as fuel in power plants. The Lott-Murkowski bill would extend the credit to cover other kinds of biomass. However, the bill would not cover landfill gas, unsegregated municipal solid waste, or paper that is commonly recycled.

THE COLOMBIAN GOVERNMENT proposed reducing the corporate tax rate from 35% to 32%. This would be the fourth tax reform since 1997.

INCENTIVES TO BURN LOCAL COAL came under fire.

Washington State was forced by a lawsuit filed by coal companies in Wyoming and Montana to drop a sales tax exemption for coal purchased for use as fuel in power plants. The exemption could only be claimed by power plants using at least 70% local coal. Local coal meant coal from the local county or a contiguous county. The lawsuit charged the exemption was an unconstitutional drag on interstate commerce. The state legislature decided to drop the 70% requirement rather than fight the suit.

Meanwhile, the Kentucky legislature voted in March to provide tax credits of $2 a ton for each additional ton of Kentucky coal that coal utilities burn above a base. Another bill provides tax exemptions for new coal-fired power plants built in coal counties.

WATER UTILITIES are lobbying Congress for legislation to clarify that the utilities do not have to report customer connection fees as income.

This includes payments to extend water mains and sewage lines. Electric and gas utilities must report payments *from customers* — as opposed to suppliers — as income. However, the water utilities worked out a special deal with Congress in 1996 — they thought to exempt such customer payments —

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Trade embargoes against India and Pakistan for nuclear testing have been suspended for five years. (The list of countries that are subject to US sanctions expands significantly if one includes countries subject to tax sanctions — like Arab nations that boycott Israel — and countries — like the Czech Republic, Poland and China — with whom buying, selling or merely acting as a broker for sales of arms, nuclear technology, or other goods specifically designed for military uses is prohibited.)

This past spring, PetroChina attempted to raise capital by selling shares in the US market. Its parent — the state-owned China National Petroleum Company — owns 40% of Greater Nile, a state-owned oil company in Sudan. Sudan is subject to US sanctions for supporting international terrorism. All "financial transactions" with government entities in the Sudan are prohibited, and US persons are barred from facilitating exports from Sudan or imports to Sudan from any country. Amidst public outcry and Congressional pressure, dozens of US pension funds declared publicly they would not buy shares, and the offering raised approximately $3 billion rather than the $10 billion initially expected.

PetroChina attempted to raise capital by selling shares in the US market . . . dozens of US pension funds declared publicly they would not buy shares.

In 1997, Gazprom — the Russian gas company — proposed a $1 billion convertible bond offering in the US. At the time, Gazprom owned a 30% interest in a project called South Pars aimed at developing a natural gas field owned by Iran and Qatar, two countries under US sanctions. The Senate Banking Committee indicated that both Gazprom and US underwriters would be violating the Iran-Libya Sanctions Act if they went forward with the offering. The offering never took place.

While compliance with US sanctions does not guarantee a successful offering, it is indispensable to it. The following is a list of steps to follow before launching an offering in the US market.

Check Sanctions

First, check whether the issuer does business with a country against which the US maintains a trade embargo. Also confirm that the issuer has not violated the broader sanctions list by participating in sales of equipment that has military uses.

Not all US sanctions apply to foreign persons. Most sanctions are "territorial" and these generally prohibit only those "persons subject to the jurisdiction of the United States" from engaging in certain activities. A person subject to US jurisdiction can be a US citizen, US resident, individual physically inside the US, corporation organized in the US, and any entity "owned or controlled" by a person subject to US jurisdiction. Often the sanctions do not spell out when an entity is subject to US jurisdiction by virtue of being "owned or controlled" by a person subject to US jurisdiction. The office of foreign assets control in the US Treasury explains that "control" could mean legal control (*i.e.* more than 50% voting power) or *de facto* control (*i.e.* controlling interest in fact), to be determined on a case-by-case basis.

As a general rule, a US issuer is always subject to the territorial sanctions while a foreign issuer is not. However, where the foreign issuer is majority-owned by a US company or is in fact controlled by a US company, it may also be subject to the sanctions.

An increasing number of sanctions are "extra-territorial." These sanctions apply to anyone who engages in prohibited activities. For instance, the Iran-Libya Sanctions Act imposes sanctions on anyone — foreign or domestic — who makes a substantial investment toward the development of Iranian oil fields. These sanctions penalize a company even if it is its parent, subsidiary or affiliate that engaged in the prohibited conduct.

Assess Impact

If the issuer is violating a sanction, the penalties imposed may prevent the issuer from raising debt or equity in the US capital markets. This issue must be looked at from the perspective of both the issuer and the potential US investor.

From the perspective of an issuer, no current sanction expressly prohibits a violating company from raising capital in the US capital markets as an issuer. The US Securities and Exchange Commission has no official position on this question, though it is working towards "greater disclosure" of the use of proceeds from any US offering.

From the perspective of a potential US investor, the answer is not so clear. When a US investor purchases debt or equity in an issuer owned by, or transacting business with, a country under US sanctions, there is a possibility that such US investor may be "transacting" business with the country under the sanction. Consequently, such investor may itself violate the applicable US sanction and face the corresponding civil and criminal penalties.

Under certain sanctions enacted by Congress, US investors are explicitly prohibited from participating in certain offerings. For instance, the Iran-Libya Sanctions Act prohibits US financial institutions from making loans or credits totaling more than $10 million in any 12-month period to develop Iranian oil fields. This effec-

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in exchange for agreeing to depreciate their assets over 25 rather than 20 years. The IRS has not administered the deal to their liking. Senator Charles Grassley (R.-Iowa) and Rep. Wally Herger (R.-Calif.) have introduced bills to address the issue. Both sit on the tax-writing committees.

FOREIGN SALES CORPORATIONS, or FSCs, remain under fire.

The European Union rejected a US proposal to allow foreign companies to claim FSC benefits provided they subject themselves to US taxation. The European Union viewed the proposal as disingenuous. Negotiations have moved out of the public eye. US companies that export through offshore, but largely paper, subsidiaries can reduce US taxes on the export earnings by 15% to 30%. Some US-made turbines have been financed through FSC leases. The US is under orders from the World Trade Organization to modify the FSC rules by October 1 or risk trade sanctions. The WTO called them an illegal export subsidy.

THE CZECH REPUBLIC is offering 10-year tax holidays for investments in new projects and five years of partial corporate tax relief for expansions of existing facilities. The new rules took effect May 1.

THE IRS IS STUDYING THE TAX TREATMENT OF CERTAIN PARTNER CONVERSIONS. The agency asked for comments on what happens when someone exercises an option to acquire a partnership interest, or converts a convertible debt instrument into a partnership interest, or converts a preferred partnership interest into a common interest. Comments are due by September 15.

COMMONWEALTH ENERGY is arguing that improvements it made in the late 1980's to a 1960-era power plant qualified for investment tax credits on

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tively prohibited major US investors from purchasing Gazprom's bonds and the offering never materialized.

Structuring Ideas

Two possible ways to structure around sanctions problems and still do a US offering are as follows.

One is to create an issuer legally separate from the entity that violated the sanction. Such an issuer can tap into the US capital-markets so long as the issuer itself is not "owned or controlled" by the entity that violated the sanction. This reduces the possibility that the investors in the offering may be deemed to violate the sanctions themselves merely by purchasing the debt or equity instruments of the issuer.

Another idea is to put into place mechanisms to assure investors that the issuer will not violate sanctions in future either directly or through an affiliate. One way to achieve this is to limit the business of the issuer. For instance, the China National Petroleum Company, which has extensive overseas activities in Sudan and Iraq, limited the scope of PetroChina's business to the domestic operations in China. Hence, it sought to reassure investors in PetroChina that invested capital could not find its way into Sudan or Iraq. PetroChina also committed that the proceeds of the offering would fund its capital expenditures and investments in China and that any proceeds that made their way directly to China National Petroleum Company would be used solely to repay borrowings and funding employee training programs. Finally, putting into place an audit mechanism to monitor the actual use of proceeds brings greater transparency to the investors and assurance that they are not unwittingly violating US sanctions. ■

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grounds that it had to make the improvements to perform under four long-term power supply agreements it had with neighboring utilities. The investment tax credit was repealed at the end of 1985. However, it could still be claimed as late as 1990 on new investment to perform a "service or supply contract" signed before 1986. Commonwealth won the case in federal district court. The case is on appeal to the first circuit court of appeals.

Delmarva Power & Light has a similar case pending in federal district court in Delaware. Delmarva argues that its franchise to serve local ratepayers qualifies as a "service or supply contract." The case involves about $25 million in tax liability.

MINOR MEMOS. The IRS business plan this year calls for rewriting so-called "true-lease guidelines" that the agency has used since 1975 . . . . The government is arguing in the US tax court that a payment a lessee made to cancel a lease is a capital loss . . . . Expect to see a "technical advice memorandum" this summer that explains when one can have a "like-kind exchange" of intangible property. A power contract is an example of intangible property. Ordinarily, converting an asset into something else triggers taxes. However, this is not true if the trade qualifies as a "like-kind exchange" . . . . The IRS continues to insist that favorable financing is not a separate asset. Thus, when one acquires a business and takes assets subject to liabilities with favorable financing terms, no part of the purchase price can be allocated to the favorable financing. The IRS made the statement in a "field service advice" to an agent in March.

— contributed by Keith Martin in Washington.

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