



THE INS AND OUTS OF CREDIT SUPPORT IN NATURAL GAS AND POWER CONTRACTING

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THE ROADMAP

OVERVIEW OF
CREDIT SUPPORT
TOOLS



SUBSTANTIVE
REVIEW OF
CREDIT SUPPORT
BY TYPE



RISK OVERVIEW
AND TOOLBOX

CREDIT SUPPORT TOOLS

Third Party Support

- **Guarantees**
- **Letters of Comfort**
- **Letter of Credit**
- **Surety Bonds**

Collateral

- **Cash**
- **Asset Liens**
- **Step in Rights**
- **Lockbox/Depository Account Control Agreements**

COMMON RISKS AND CONSIDERATIONS WITH THIRD PARTY SUPPORT

- Creditworthiness of the Third Party
- Presentment and Demand to Third Party
- Enforcement against the Third Party

TYPES OF CREDIT SUPPORT:

THIRD PARTY GUARANTEES

- **Parental Guarantees:** A contractual obligation where a parent entity assumes responsibility of payment or performance of an action or obligation of its subsidiary by agreeing to compensate the beneficiary in the event of non-payment or performance.
- **Subsidiary/Upstream Guarantee:** A contractual obligation where a subsidiary company guarantees the payment or performance of its parent company.
- **Cross Guarantees:** A contractual arrangement between two or more related companies to provide a guarantee for each other's obligations.
- **Joint Guarantees:** “Joint and Several” – pursue the entire claim against one party versus “Joint but not Several” – each party is liable for its portion and no more.
- **Letters of Comfort:** a written document where a parent company provides assurance that its subsidiary's obligations will be met.

GUARANTEES – RISK CONSIDERATIONS AND USAGE

Usage

- In Credit Support Annexes/EEI used primarily to backstop unsecured credit – “amount the counterparty is willing to put at risk”
- Under the NAESB the guarantee is a Credit Support Obligation and the failure to perform on it is therefore an event of default.

Risk Considerations

- Examine the creditworthiness of the guarantee carefully if it backstops an unsecured threshold. If a subsidiary goes bankrupt the parent is likely to follow.
- Consider enforceability of the guarantee particularly with foreign guarantors and include an arbitration provision.

GUARANTEES – TECHNICAL

- **Terms of Art:**

- **Unconditional:** Performance is required of the guarantor without the satisfaction of any conditions by the creditor or the obligor. Oftentimes used synonymously with Absolute.
- **Absolute:** 38 Am.Jur 2d – creditor may proceed directly against the guarantor without exhausting remedies against the Obligor. Restatement of Suretyship & Guaranty (3rd) – guarantor does not need to be notified of incurring an obligation.
- **Continuing:** a guarantee of present and future obligations of the Obligor.
- **Irrevocable:** A guarantee may not be rescinded. A guarantee may be revoked as to future obligations not yet incurred.

GUARANTEES - DEFENSES

- **Suretyship Defenses:**
 - Release of Obligor, Extension of time for the Obligor's Performance, Other modification of underlying obligation, Impairment of collateral or recourse against others
 - Bankruptcy
 - Dissolution
 - Obligor's defenses.
- **Waivers:**
 - "All Suretyship Defenses"; Rescission of Payments
 - Careful not to waive Obligor's defenses except bankruptcy and dissolution.

GUARANTEE DRAFTING CONSIDERATIONS



- Defining Guaranteed Obligations
- Defining ability to request payment – failure to pay; event of default
- Guarantee Cap and Costs
- Presentments and Demands
- Recourse to Collateral
- Recoupment
- Arbitration for Foreign Guarantors

LETTERS OF COMFORT



Normally drafted to avoid any enforceable legal obligation.



The risk is that the letter will be construed as a guarantee. Since a guarantee is simply a contractual obligation any language that can be construed as the issuer's agreement to meet the obligations of an obligor could inadvertently create a surety obligation.



Particularly in foreign jurisdictions, Letters of Comfort may be construed as legal and enforceable obligations.



When taking a Letter of Comfort do so assuming it is informational as opposed to a binding obligation of support.

TYPES OF CREDIT SUPPORT: THIRD PARTY GUARANTEES – LETTERS OF CREDIT

- **Standby Letter of Credit:** A contractual arrangement whereby a bank guarantees the performance of one of the parties to a contract such that if the party does not perform its obligations, the bank will. In the event of non-performance, the beneficiary provides a draft certifying the non-performance for payment on the Letter of Credit.
- **Documentary Letter of Credit:** A contractual arrangement between a bank on behalf of one of its customers (i.e., a buyer in an international sales transaction) authorizing payment of the sales price by the bank upon delivery of the product by the seller and presentation of prescribed documentation by the seller upon the bank.

Differences: Documentary Letters of Credit are used for payment while Standby Letters of Credit are used to guarantee performance in the event the primary obligor does not perform.

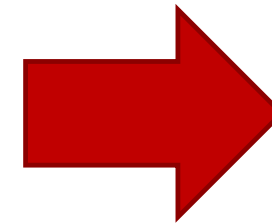


STANDBY LETTERS OF CREDIT - THE PLAYERS

- The Issuer: The bank undertaking the payment obligation.
- Beneficiary: The party entitled to payment by the bank upon provision of the requisite documentation
- Applicant: The banks customer on whose behalf the Issuer issues the Letter of Credit; the party contractually obligated under the Letter of Credit facility with the Issuer.
- Account Party: The obligor on behalf of whom the Letter of Credit is issued if not the Applicant, normally an affiliate of the Applicant who is utilizing such affiliate's Letter of Credit facility.



Issuer



Beneficiary

STANDBY LETTERS OF CREDIT

- OTHER PLAYERS

- Correspondent Bank: Agent Bank for the Issuer, usually located in Beneficiary's home country and has an existing banking relationship with the Beneficiary.
- The Advising Bank: Usually a foreign correspondent bank of the Issuer that will advise the Beneficiary that i) the LC is valid and ii) will be responsible for sending the LC to the Beneficiary. The advising bank has no other obligations even if listed as the payee bank, in which case it will wait for funds from the Issuer before making payment. Allows the Beneficiary to deal with a bank in its home country and expertise regarding validity of the LC.
- The Confirming Bank: A bank, advising or otherwise, that assumes the same responsibilities as the Issuer including the obligation to pay against the presented documents. In effect, the Beneficiary then has the individual promise of two banks to pay against the conforming documents – the Issuer and the Confirming Bank. Helpful in countries where economic or political factors may impact payment and allows the Beneficiary to deal with a bank in its home country.

STANDBY LETTERS OF CREDIT CONTRACTUAL PROVISIONS V. LETTER OF CREDIT FORM



- **Contractual Provisions**
 - Specify how LCs used for Collateral or Adequate Assurance support
 - Specify how the Agreement is defaulted based on a Letter of Credit Failure
 - Specify how substitutions occur
 - Specify credit requirements for issuer
- **Letter of Credit Terms**
 - Specify draw conditions
 - How LC can be presented and exercised
 - Governing terms

STANDBY LETTERS OF CREDIT – CONTRACTUAL PROVISIONS

Use

- Specify how letters of credit can be used contractually
- Performance Assurance (as in EEI and NAESB)
- Margining (as in a Credit Support Annex/Addendum)

Issuer's Credit

- EEI Requirements: A- from S&P and A3 from Moody's
- Industry Standard Qualified Institution Definition: A- or A from S&P and A3 or A2 from Moody's and assets requirement of \$1 billion or \$10 billion.

Letter of Credit Defaults

- Issuer credit requirement failure (EEI)
- Issuer disaffirms, disclaims or repudiates the LC (EEI)
- LC expires or terminates and fails to be in full force and effect. (EEI)
- Issuer is bankrupt (EEI)
- LC expiring within a certain time (20/30 calendar days) without substitution

STANDBY LETTERS OF CREDIT – CONTRACTUAL PROVISIONS

Substitutions

- Failure to honor by Issuer (EEI)
- Failure to renew by an Issuer or indicated it will not renew (EEI)
- Bankruptcy or other credit event of Issuer
- Issuer fails to meet Issuer credit requirements
- Applicant/Pledgor can substitute within a certain number of days (1(EEI)/2/3 Business Days standard)

Draw Rights and Conditions

- In accordance with the specific requirements of the Letter of Credit
- Right to draw on Event of Default
- Non-payment or performance
- Expiry within a certain number of days (20/30 calendar days)
- Specify Pledgor's rights if Secured Party default under CSA

General Provisions

- Specify the value attributed to the LC if used as collateral. The closer to expiry the lesser the value. Generally 20/30 days before expiry value is \$0 forcing a substitution
- Specify how LCs amended or additive for margining
- How drawn LC amounts will be applied if used for margining.
- If Revocable/Irrevocable or Transferable/Non-transferable

LETTERS OF CREDIT - REVOCABLE V. IRREVOCABLE/TRANSFERABLE V. NON-TRANSFERABLE AND ASSIGNMENT OF PROCEEDS

Revocable v. Irrevocable

- Revocable: At any time prior to demand, can be unilaterally amended or cancelled by Issuer without Beneficiary's consent. Only if expressly stated in LC.
- Irrevocable (EEI Standard): Cannot be changed without the prior consent of the parties (EEI Standard).
- Default Rule: Silence = LC is irrevocable, ISP98, U.C.P. 600, UCC Revised Article 5.

Transferable v. Non-Transferable:

- Transferable (EEI Standard): If expressly provided in the LC, the Beneficiary can transfer its right to demand payment and draw under the LC to a third party.
- Issuer can still refuse to recognize the transfer if it violates applicable law or the Beneficiary or assignee fail to comply with transfer requirements in the LC or under UCC § 5-112(b). Allows Credit Support to be transferred with an underlying agreement.
- Non-Transferable: Beneficiary cannot transfer its right to demand payment and draw on the LC to a third party. Transfer of underlying agreement would necessitate a cancellation of LC and reissuance to assignee.

Assignment of Proceeds:

- Applies whether the LC is transferable or non-transferable, but the third-party assignee has no right to draw, instead the Beneficiary must draw.
- If assignee is holding the LC and the presentation of the LC is a condition of payment under UCC § 5-114(d), Issuer consent is still required but cannot be unreasonably withheld.

STANDBY LETTERS OF CREDIT

– LETTER OR CREDIT TERMS – UCC, UCP, ISP

UCC Article 5 (“UCC”): A statute adopted in all 50 states. Documentary and Standby LCs

Uniform Custom and Practice for Documentary Letters of Credit (“UCP”): International Chamber of Commerce (1933). Most recent version is UCP 600 which replaced UCP 500 (still occasionally in use). Specifically drafted for Documentary LCs not Standby. A standard not a law that must be elected in the LC.

International Standby Practices 98 (“ISP 98”): First alternative to UCP for standby LCs. A standard not a law that must be elected in the LC.

Even if specify UCP or ISP – UCC still applies. Best practice is to specify UCP or ISP98 and that these standards will trump the UCC but UCC will still operate as a “gap filler”.

STANDBY LETTERS OF CREDIT

– LETTER OR CREDIT TERMS – UCC, UCP, ISP



- Expiration of LC during Issuer Force Majeure: ISP98 extends term 30 days, UCP does not.
- Transferable LC: Single v. Multiple transfers and Partial Transfers: UCP refers to partial shipments and drawings pertaining to Documentary LCs/Commercial sales transactions. ISP98 provides for multiple entire (as opposed to partial) transfers. Partial transfers are generally not allowed so if a partial transfer is contemplated it must be specified in the LC.
- Time Permitted for Issuer's examination of documents: UCC: Reasonable time not to exceed 7 days; UCP 600: 5 banking days; ISP98: 3 business Days.
- Expiry on non-Business Day: ISP98 provides for the extension of the expiry by a day if expiry occurs on a non-Business Day.

STANDBY LETTERS OF CREDIT – LETTER OR CREDIT TERMS

Draw Conditions

- Event of Default
- Non-Payment
- If using for collateral be careful of “invoice” language and documentation requirements.

Presentment and Payment:

- Presentment at counter reasonably close to Beneficiaries place of business
- Add electronic presentment (fax/email)
- A time limit for payment
- Check procedures and Issuer deadlines

TYPES OF CREDIT SUPPORT: THIRD PARTY GUARANTEES – SURETY BONDS



- **Contract Surety Bonds:** Most prevalent in construction contracts but becoming more common in energy contracting.
Most common bonds in energy contracting:
 - **Payment Bonds:** intended to protect a party from the other party's failure to pay its obligations (traditionally used to ensure contractors and suppliers are paid in construction agreements).
 - **Performance Bonds:** intended to protect a party from the other party's failure to perform (traditionally used to protect the owner from a contractor default in a construction agreement).
- **Commercial Surety Bonds:** Required by local or state law to comply with state or federal regulations (i.e., custom bonds, tax bonds, workers compensation self-insured bonds).

SURETY BONDS – PROS



- Often highly rated.
- Issued by well-established Insurance Companies.
- Alternative support issuer for entities with non-qualified institution lenders/letter of credit providers.
- Bond companies offer competitive rates versus letter of credit issuers.

SURETY BONDS – CONS



- Not yet widely used in the industry although gaining interest as pipelines and ISOs have begun accepting them as collateral.
- Consider if verbiage is fit for purpose and is not just a redrafted construction bond form.
- Read the draw language carefully to ensure immediate payment as opposed to payment after collection or some other delaying language.
- No industry standard terms for indemnity agreements, surety bonds or to add to Master Agreements/Credit Support Annexes.

SURETY BONDS CONSIDERATIONS

Indemnity Agreement:

- Obtaining a Bond requires signing an indemnity agreement which generally includes payment of the premium and the right to call collateral security to backstop the bond. Onerous terms for the Indemnitor which includes a full indemnity against claims against the surety including payment of costs and fees.
- Often includes a change of control clause and a notice requirement; step in rights to the underlying contract; specific performance.

Surety Bond:

- Should include similar draw conditions to Letters of Credit.
- Be mindful of the timing – often bonds will have a longer time to pay than Letters of Credit. Make sure the bond is immediately payable on demand as opposed to payable after collection.
- Include electronic presentment.

Master Agreement/Credit Support Annex

- Language similar to letter of credit provisions should be built to address bond defaults, valuation, returns, amendments and ability to draw and hold cash collateral.
- Include a Qualified Institution Standard to insure a highly rated Issuer.

TYPES OF CREDIT SUPPORT:

COLLATERAL – CASH; ASSET LIENS; STEP IN RIGHTS; LOCKBOX

- **Cash:** medium of exchange governed by governmental currency laws.
- **Asset Liens:** A security interest in the assets of a company in the form of inventory, equipment, tangibles and intangibles. Entitles the owner of the security interest to the proceeds of sale of the assets commiserate with the priority of the security interest.
- **Step in Rights:** Contractual right to assert ownership over an asset upon a default.
- **Lockbox:** A mechanism to collect and hold amounts collected as accounts receivable for the benefit of the beneficiary to meet the contractual obligations.
- **Depository Account Control Agreements:** tri-party agreement between a bank, the bank's account holder and a secured party where the bank agrees to comply with instructions from the secured party directing disposition of the funds in the account without further consent of the account holder.



COMMON RISKS AND CONSIDERATIONS WITH COLLATERAL

- Speed of exercise and other conditions
- Security interest concerns – how to attach and perfect properly.
- Proper documentation of rights

ASSET LIEN STRUCTURE – HOW IT WORKS

- Asset collateral provided to a counterparty to backstop contractual obligations. Assets may include generation assets/equipment, real property, receivables and accounts, inventory or any other available assets.
- If the assets have not otherwise been pledged:
 - Understand the nature of the collateral and its classification under the UCC or under Property Law (i.e., inventory, equipment, mortgage, fixture, etc.)
 - assets must be attached (the security interest properly granted to the secured party) by the pledging party 1) giving value for the interest in the collateral 2) which it has rights to and 3) the pledging party must execute a security agreement; and
 - The security interest must be perfected (effective in respect of third parties) in the method for the collateral type as specified in the UCC or under real property law. This generally means possession or filing of a financing statement/security agreement or other documentation (mortgage/lease) in the office specified for that collateral type under the UCC or real property law.

FIRST LIEN STRUCTURE

Lender with existing first lien agrees to share first lien with other creditors. Execution of an inter-creditor agreement/accession agreement to an existing inter-creditor agreement.

Examine the credit agreement and the inter-creditor agreement for the priority of payments upon liquidation of the collateral (the “**Waterfall**”). Counterparty obligations should be **pari passu (equal in right)** – paid at the same point in the waterfall – with lender obligations. Also check the Permitted Liens Section of the Credit Agreement/Inter-Creditor Agreement to ensure first liens can be extended to the commodity/swap obligations.

Credits officers should understand:

the asset valuation and any re-evaluation mechanism

the amount of outstanding obligations covered by the Liens

mechanism to liquidate the collateral

the compliance reports provided by the debtor

FIRST LIEN STRUCTURE; MASTER AGREEMENT LANGUAGE; COUNTERPARTY ADDITIONAL TERMINATION EVENTS

- Include Additional Termination Events:
 - Failure to comply with Credit Agreement Covenants;
 - Security Interest events:
 - Obligations not secured by a valid and perfected first priority lien on all of the Collateral
 - Obligations are not pari passu with the lenders for purposes of priority and payment upon liquidation.
 - Any portion of the collateral is released in violation of any covenants, Credit Agreement or Inter-creditor Agreement.
 - A casualty or condemnation event occurs with respect to collateral and the project party does not repair the assets materially impairing, in the opinion of counterparty, the ability to perform under the agreement.

* For ISDA purposes, make sure to list project company as the sole Affected Party and such Transactions as Affected Transactions as this is an Additional Termination Event.

FIRST LIEN STRUCTURE; MASTER AGREEMENT LANGUAGE

- Credit Support Document definition includes Credit Agreement, Inter-creditor Agreement and any other collateral documents.
- Documents to be delivered under the Master Agreement:
 - Debtor provide document certifying that is has provided all required notice to the collateral agent that creditor is included in the first lien.
 - Certification that the Transactions/obligations are permitted under the Credit Agreement.
 - Include the Credit Agreement, Inter-Creditor Agreement and signed Accession Agreements as documents to be delivered under the Master Agreement.
 - Copies of notices of default/financial statements required to be provided to Lenders under the Credit Agreement
- A covenants schedule or an incorporation of covenants by reference to the Credit Agreement or Inter-Creditor Agreement.

FIRST LIEN STRUCTURE; MASTER AGREEMENT LANGUAGE; TRANSFER

- If the Transaction is tied to a project, consider how a transfer of ownership of the project will affect a transfer of the Transaction:
 - Will a substitute cash collateralization be acceptable?
 - Will a guarantee from a highly rated guarantor be acceptable?
 - Will asset collateralization in a form and substance of the existing lien structure be acceptable?
 - Include language that:
 - No existing disputes with the transferee party;
 - Transfer will not create any regulatory, permitting or consent violation;
 - Transferee party is an experienced project operator; and
 - The transferee party accepts and assumes all the obligations under the Master Agreement.

FIRST LIEN STRUCTURE; MASTER AGREEMENT LANGUAGE, ADDITIONAL REPRESENTATIONS

- Include debtor representations that:
 - The Transactions/obligations under the Master Agreement are permitted under the terms of the Credit Agreement and Inter-creditor Agreement;
 - Define such permitted transactions as they are defined in the Credit Agreement or Inter-creditor Agreement;
 - The Transactions/obligations are entitled to first lien status and treatment.

CONSIDERATIONS FOR DEBTORS GRANTING FIRST LIENS

- Limit the included Credit Agreement covenants to only those that should be applicable to the obligations;
- Include transferee language to provide maximum flexibility to transfer assets;
- Include language allowing for assignment of revenues and proceeds of the Transactions/obligations in connection with the financing;
- Limit the reporting under the Master Agreement;
- Credit Event upon Merger not applicable if merger is to a Subsidiary;
- Cross Default Threshold should mirror the Cross Default Threshold in the Credit Agreement; and
- Cross Acceleration rather than Cross Default by removing “or becoming capable at such time of being declared”.

STEP-IN RIGHTS

Possession of Assets: First Lien does not allow the lien holder to automatically take possession of assets upon a default. To allow for a party to take possession there must be step in rights provided in the contract as a contractual right.



Considerations:

Step in Right Holder needs consent right to any future liens and needs to understand any existing liens and effect on the assets upon step in.

Think about and document how step in occurs including notice; transfer requirements, timing, transition of operations, etc.

Think about if step in requires asset title transfer or involves a governance change in an entity. Include provisions making clear how either scenario would occur.

LOCK BOX STRUCTURE



Customer (Debtor) owes money to Creditor which is paid to a specified account.



Creditor and Debtor enter into a control agreement with bank to instruct the account or account is in Creditor's name.



Creditor obligations paid out of lockbox and any remaining amounts go to Debtor.

TYPES OF LOCKBOXES

Soft Lockbox: Revenue stream is directed into the Lockbox and are subsequently swept to the pledgor based on a condition being met (timing; threshold overage)

Hard Lockbox: Revenue stream is directed into the Lockbox which is then used to pay any amounts due under the contract and remaining amounts are held except for identified amounts for use as operating expenses.

Springing Lockbox: Either a Soft Lockbox or Hard Lockbox structure are pre-established, but the account is not opened and operable until trigger event occurs which allows the creditor to establish the account.

CREDITOR CONSIDERATIONS

- Location of the Lockbox;
- Structure the Lockbox:
 - Control Agreement:
 - Execute a Security Agreement where the Debtor pledges the Account to the Secured Party;
 - Control Agreement between the Debtor, the Creditor and the Bank establishing how the Creditor can seize/instruct the account; or
 - Deposit Account in the name of the Creditor.
 - In the Master Agreement include provisions that address:
 - Address how amounts will be paid to the Creditor and how remaining amounts will be remitted to the Debtor.
 - What information will the Creditor receive about the account? Statements, deposits, withdrawals, etc.
 - Include a minimum value in the account that can never be swept?
 - How do you ensure that the Customers are properly instructed, and are actually paying, into the proper account.

DEPOSITORY ACCOUNT CONTROL AGREEMENT/LOCKBOXES

A Creditor can establish “control” of cash revenues in any of the following ways:

- the Creditor becomes the actual owner of the pledgor’s deposit accounts with the pledgor’s depository banks; or
- The Creditor and pledgor enter into a deposit account control agreement (“DACCA”) with the Pledgor's depository bank.
 - "blocked" control agreement - no pledgor access to the funds; Creditor will have complete control over the funds.
 - “springing” control agreement – pledgor access to the account until the Creditor delivers notice of exclusive control to the bank.
- These arrangements are, in all cases, in addition to the security agreement through which the pledgor grants a security interest in its deposit accounts.

LOCKBOX MASTER AGREEMENT LANGUAGE

- Include Additional Termination Event for closure of account, breach, expiry or repudiation of the Control Agreement, failure to maintain the minimum amount in the account and customer failure to remit amounts into the account.
- Include Security Agreement and Control Agreement as Credit Support Documents under the Agreement;
- If no separate Security Agreement, include security agreement provision in the Agreement;
- Include Representations and Warranties that the Security Agreement and Control Agreement are duly authorized by the debtor company and allowed under that Company's financing documents;
- If there is a conjunctive Credit Support Annex, tie the amount in the account to the unsecured threshold so amounts above the receivables are cash/LC collateralized.

THE CREDIT TOOLBOX

Tool	Pros	Cons
Guarantee	Additional entity for recourse; allows access to higher credit entity	Rolling bankruptcy concerns.
Letters of Credit	Access to third-party recourse without relation to the other party.	Issuer default including bankruptcy.
Surety Bonds	Access to third-party recourse without relation to the other party.	Issuer default; new product; additional time to pay; recourse limited to reimbursement by applicant.
Asset Liens	Availability to proceeds of sale of concrete assets; larger pool of available collateral	No decision-making ability on liquidation; time for sale and distribution; asset deterioration/forces sale discounts proceeds pool.
Step in Rights	Provides actual right to concrete asset	Ability to operate asset, timing concerns; transition concerns
Lockbox	Access to revenue stream representing immediate cash collateral	Structuring and documentation issues

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