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Progress (Finally) on the Pledged Share Dilemma

Among the more intractable challenges in **structuring and closing** infrastructure project financing in emerging markets has been the tug-of war between project lenders and political risk insurers (of equity) for control of project shares in the event of an expropriation. The Export-Import Bank of the United States ("Ex-Im Bank") and the Overseas Private Investment Corporation ("OPIC"), two U.S. government agencies that have been principal supporters of U.S. businesses active in emerging market infrastructure projects, have also struggled with this dilemma. After years deal-by-deal negotiations, OPIC and Ex-Im Bank have reached an overall resolution, reflected in a "Joint Claims Agreement" signed March 18 (the "Agreemerif').

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The last decade has seen explosive growth of private business participation in the development and operation of infrastructure in emerging markets. The developers usually seek to leverage their equity investments with significant *project* debt to be provided on a limited recourse basis, a so-called "project financing." A core piece of the collateral package typically structured to secure project debt is a lien on the shares of stock sent in investment.

In the challenging markets where these projects have been undertaken, project sponsors often seek political risk insurance on their equity investments. Under the terms of OPIC's expropriation coverage, the insured investor must deliver to OPIC ***its unencumbered*** shares in the expropriated company in order to receive compensation. This traditional provision has come into obvious conflict with the now prevalent practice of securing project debt with a pledge of shares. If an expropriation were to occur, the project sponsors could find themselves holding only encumbered shares and thus unable to collect for OPIC.

This development led OPIC to ask project lenders to agree, in the event of an.expropriation, to release its ,.edge on project shares. OPIC has asserted that: (1) it needs unencumbered shares in order to have adequate salvage; (2) pricing to

the enhanced salvage risk of accepting pledged shares is not feasible; and (3) any sharing *of claims proceeds* needs to be subject to the lender's proof of a valid international law claim against the expropriating government, a hurdle of uncertain height since the actual circumstances of a particular expropriation could not be known in advance.

On the other hand, Ex-Irn has maintained that: (1) the political risk insurer of equity should not expect the collateral package supporting project debt to be undermined in order to facilitate equity insurance; (2) it was not feasible to price the risk associated with promising to release the lien on pledged shares in the event of an expropriation; and (3) to the extent of any uncertainty as to the legal standing of the debt claim following an expropriation, it was all the more critical to have the right to foreclose on the shares and thus to stand in the shoes of the equity. In addition, because Ex-Im Bank is typically only one among several lenders, the problem is

not solved merely by strWng an interagency understanding since an agreement with Ex-Im would not hind commercial or other official lenders.

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Previous interagency discussions were characterized by efforts to elaborate a variety of possible expropriation scenarios and to attempt to agree on a specific way of handling each. The Agreement was reached by abandoning this approach and by agreeing instead on a principle, namely, that, if an expropriation occurs, each agency would cooperate with the other in order to maximize their total joint recovery from the expropriating government. The details of what that would require are left to be determined in the context of the actual expropriation on.

The Agreement also provides that the proceeds of any settlement will be shared between the agencies pro rata in proportion to their respective exposures to the expropriated project. This reflects their agreement that each investor's claim, both debt and equity, should be treated as equally valid and deserving of compensation from the expropriating government.

The Agreement provides further parameters for post-expropriation cooperation: a stay of execution of the share pledge once OPIC notifies Ex-Im that an expropriation bas occur-ed-, a waiver of any share retention obligations that could impede the assignment of insured shares to OPIC to perfect an insurance claim; a two-year window within which Ex-Im may choose to accept the credit of the post-expropriation entity and opt out of pressing a joint claim with OPIC, though it would still, if needed, release its share pledge; and a provision regarding the allocation of expenses. The fundamental effect of the Agreement is, however, to commit each agency to the principle of endeavoring to achieve maximum postexpropriation recovery, with the particular steps required to achieve that goal being left to be determined if and when an expropriation of an OPIC- mid Ex-Im supported project occurs.

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Although OPIC and Ex-Im have now reached agreement, roost maj or infrastructure *projects involve* multiple commercial and official lenders and political risk insurers. Where lenders or political risk insurers other than OPIC and Ex-Im are at the table, the share pledge problem remains a hurdle to be cleared deal-by-deal, posing the continued likelihood of lost time and legal fees as the pledged share battle is continuously re-fought.

Consequently, an important open question is whether other lenders and political risk insurers will be willing to go along with this - or some other - model to resolve the pledged share conflict. A prevalent view amongst those involved in negotiating the Agreement was that the accord made sense (only) because the two agencies were part of the same fiscal family so that the taxpayers' sole interest is in maximizing the post-expropriation recovery. The interagency allocation of those proceeds was of no importance to the federal budget, If, however, insurers and lenders lacked some common institutional bond,, there was a presumption that the pledged share conflict would continue.

Most lenders and insurers have, however, no such familial ties. So, if such ties prove to be critical for a once-and-for-all, conventional solution to the pledged share problem to emerge, then the prospects for such a general solution are exceedingly dim.

On the other hand, the principle of maximizing the total - in contrast to permitting an expropriating government to play competing claimants off against each other during settlement negotiations - makes good

sense for investors to a project~ whether or not they share any affiliation other than their respective exposures to the expropriated project. If agreement to act jointly is to be reached, however, the question of how to allocate settlement proceeds needs, as in the OPIC/Ex-Im Agreement, to be confronted. Lenders may continue to insist that satisfaction of equity claims against the expropriating government must be subordinated to their debt claims. Equity insurers may continue to insist on (at least) pro rata allocation and even to hesitate to commit in advance to join forces in pressing joint claims with lenders. If so, then the pledged share standoff may continue to plague international project financing in emerging markets.

Alternatively, each side may conclude, as did OPIC and Ex-Im, that the details of the post-settlement sharing formula are of less importance than the certain benefits to be achieved by cooperating to maximize joint recovery and by removing this conflict from the agenda of issues needing to be negotiated up front. Such an outcome would guarantee a reduction in the up-front costs of bringing many emerging market project financing to closure.