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INTERNATIONAL FINANCIAL LAW REVIEW

ESCO cross-border and internal financing

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Spasov & Bratanov

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The Lawyers' Partnership Spasov & Bratanov was established in 1999 by the two name partners. It is a civilian partnership under the Bulgarian Obligations and Contracts Act and the Advocacy Act. The partnership has developed and maintains correspondent contacts with lawyers and law firms in Sofia and throughout Bulgaria, as well as with governmental, municipal and independent agencies.

The partnership also works with and provides legal opinions on international matters for a number of foreign law firms – notably in the UK and central Europe, following on from its earlier affiliation with a now restructured international law firm. Spasov & Bratanov is now included in the European Bank for Reconstruction and Development (EBRD) list of local legal consultants, as well as in the EBRD DIF database, the Black Sea Trade and Development Bank consultant list and the World Bank/IFC consultant database DACON. The partnership is a member of the UK-Bulgarian Chamber of Commerce. Chambers Global 2003 has honoured the partnership by ranking it as an outstanding law firm in Bulgaria.

The partnership is among the very few independent Bulgarian law firms to have effected professional liability insurance cover.

The partnership is of counsel to a number of state, municipal, private and foreign entities, relating to legal structures, mergers, acquisitions and subsidiaries, liquidation and insolvency procedures; commercial contracts; privatization; foreign investment; concessions; competition law; taxation and tax relief; banking and financial contracts; bonds, promissory notes and related instruments.

One of the partnership's main areas of expertise is the provision of local legal advice on large international projects, acting either directly for foreign clients or for other international law firms. In order to meet short-term human resource requirements for such participation, the partnership has established team arrangements with a number of other independent, established local lawyers. This team cooperation has proved itself effective, flexible and financially advantageous to the client. The partnership has also formed special purpose large teams with economists and engineers for particular projects.

The partnership works in Bulgarian, English and Russian.

It is the partnership's policy to encourage trainee lawyers, who are usually undergraduates in Law. Spasov & Bratanov generally employs three trainees. The firm has trained Bulgarian undergraduates from German and English law schools, and in 2004 expects a French graduate to join as trainee.

Some of the projects recently handled by SPASOV & BRATANOV include:

Banking and finance

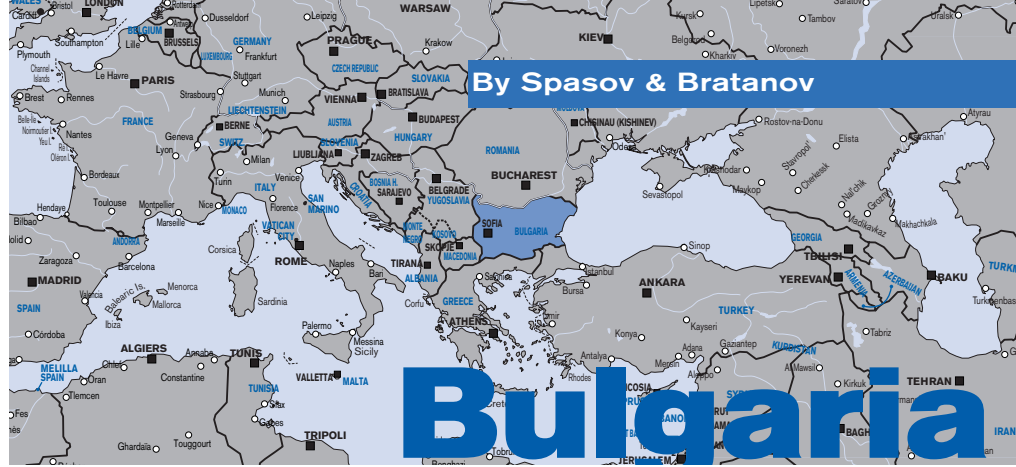
- Providing preliminary advice, independent examination, support in negotiations and assisting in discussions; drafting (within the context of Bulgarian law) of the international agreements on the €200 million European Financing for a nuclear power plant in Bulgaria, and providing legal opinion, acting on behalf of the lender.
- Providing legal opinion for the lender on the \$80 million external financing for the nuclear power plant in Bulgaria.
- Providing continuous advice and opinion on a €70 million bridge loan facility where the firm acts for a large European Bank and is involved in a €160 million project loan facility, acting for the arranger and co-lender.
- Providing continuous advice, negotiations support, amendment to loan documentation, legal opinion and drafting of security agreements for the lender (a big international financial institution) in an €35 million investment loan to a local public institution.

Concessions and energy

- Advising on the legal framework of a concession bid by a foreign company for the water concession of the Sofia Municipality. Advising the same company, on the Varna-Shumen Water and Waste Water Concession – ongoing under the auspices of the World Bank PSP project – involving more than 20 municipalities where Spasov & Bratanov has completed the framework report, the due diligence and certain reports on the formation of the bid documentation package. The firm has also reviewed and given opinions on the draft concession contract and related instruments.
- Rendering ongoing legal advice to a foreign investor company on its operation of a substantial oil and gas exploration and production business to include drafting and reviewing of various agreements, advising on the legal aspects of project financing, creation and perfection of various types of security and advising and implementation on transformation of companies.
- Continuing advice and issuance of legal opinions for the foreign investor in the first large-scale energy-saving project, awarded by a public entity to a foreign-controlled local company under public procurement. In this case, Spasov & Bratanov has also advised the foreign investor during the acquisition of control process, the procurement procedure and the financing of the performance.

Mergers and acquisitions

- Acting as principal instructing lawyers to local lawyers on several transactions totaling more than €4 million towards the takeover of a public company in a neighbouring country.



ESCO cross-border and internal financing

Structured finance is vital in project financings where the project does not have even and regular cashflow. In Bulgaria, structured finance is usually engineered by the lending banks, mostly for bank supervision purposes rather than for business purposes.

ESCO projects in central heating – which in Bulgaria is a five to six month cash-generating business with investment also occurring during the rest of the year – are typical examples of projects which require structured finance. But there is very little experience with this type of financing in Bulgaria. For this reason, managing and optimizing cashflow – including combining alternative sources for investment and working capital – is a must. This article provides a description of an actual transaction, the first of its kind in Bulgaria.

CASE STUDY: AN ONGOING CENTRAL HEATING TRANSACTION

Energy saving projects (ESPs) are quite new in Bulgaria and there is little regulation. The 1999 Energy and Energy Efficiency Act (EEEA) had certain relevant provisions (abolished in 2000). These stated that the implementing company must provide for the funding of the energy-saving measures and could receive payments (including towards reimbursement of costs) only from actual savings in the cost of the consumed energy. While these provisions were not effective by the time of the tender in this case, the public authority organizing a public procurement tender to ensure the performance of the ESP in question, chose to apply them.

An SPV, in the form of a Bulgarian shareholding company, was created for the tender as a joint venture between Bulgarian shareholders and a large foreign company. The SPV was funded at low cost through its endowment capital only. As the tender cost more than expected, the shareholders had to credit its operations, but in the end, this company won the ESP tender.

Thereafter, the foreign company negotiated to take over control of the SPV and the costs of the selling shareholders were reimbursed through the purchase price for their shares. Thus the SPV had a fresh start in terms of its balance.

As part of the tender, the awarding authority was committed to facilitating a bank loan and to providing security towards it because substantial investment was required under the project and the return was expected in arrears over the following years. The loan was arranged with an international financial institution, but as pure project financing is costly and still unusual in Bulgaria the negotiation was stopped in anticipation of the controlling shareholder providing trade financing to the SPV.

The seasonal nature of the business required the investment under the awarded contract to begin at a particular time. This meant that the SPV had just a few months to make costly energy efficiency improvements before the heating season started. As more improvements were made, more benefits under the project were realized during the season.

Because of this narrow timeframe, and in anticipation of funding from the

About the authors

GEORGI SPASOV

The managing partner of the firm holds an LLM (London) degree in Banking and Finance Law. He was the principal lawyer for Bulgarian advice in a number of large cross-border transactions, including IFIs and banks' loans to sovereign and private entities, concession procedures, project and trade finance, as well as in securities regulation advice. He has acted as the instructing lawyer on acquisitions in another jurisdiction. He also teaches seminars in commercial law to undergraduates and speaks at a number of international conferences. Mr Spasov has gained experience in legal studies in Japan, the UK and the Netherlands.

JANA DJAMBAZOVA

Jana Djambazova joined the firm as a partner in 2001, after being the head of legal practice at KPMG (Bulgaria) for more than six years. Before that she was a senior lawyer with Price Waterhouse (Bulgaria). She is well-versed in mergers and acquisitions, concessions and energy law, project finance, any due diligence assignments and in real estate and planning law. She has attended a number of legal conferences abroad. She also holds a degree in Psychology.

controlling shareholder which did not materialize, the SPV had to revert to trade financing and trade credit by its suppliers and sub-contractors. This was quickly arranged and the implication of the planned investment started on time. The arrangement was particularly attractive because of its tax implications, as the contracts between the parties involved and the SPV were structured in a manner in which the suppliers took the customs clearance duties for the imported goods and the SPV had only deferred payment liabilities to its suppliers and subcontractors. Certain provisions of Bulgarian real estate law did not allow the SPV to acquire interest in rem in these goods, because, by reason of its attachment to existing property, title was acquired directly by its owner (the awarding authority). This structure of performance contracts brought two advantages – first, the SPV enjoyed the gearing of a bank (it had only financial claims and liabilities); and secondly, this structure was extremely tax effective as there was no extra tax liability on a chain of transfer of title on the relevant assets.

Certain problems in the planned cashflow arose. The cashflow was based on a proportion of the decreased costs for the heating of the beneficiary, based on reference data from previous seasons, and taking into account the climatic differences and the costs of energy fluctuations. This precise but complex methodology caused difficulties especially where, because of an increase in energy costs, the savings were notional and not easily seen compared to the relevant absolute figures. As the beneficiary was a public authority the accounting and financial rules for budget entities were not flexible enough to accommodate this unusual type of financial structuring. As a result, invoices issued by the SPV were not paid for months, which besides jeopardizing the planned cashflow, also increased the financial stress on the SPV as issued invoices incurred unconditional tax liabilities, regardless of the lack of actual payment.

To end the trade finance exposure it was decided that the parties involved should revert to bank loan sources. A foreign-controlled local bank was interested in the project, and tried to structure a loan instrument for the SPV, despite its short business history and lack

of credit history, designed as immediate borrowing of the ceiling amount under a term loan and its repayment in uneven installments after a grace period. To allow flexibility with a view to avoiding formal default, the repayment was structured so that large payments would be made in the months when the SPV did not have actual income, but would have collected its receivables under the project. A registered pledge on these receivables was the primary security designed and an off-balance sheet charge on receivables was used to provide working capital for the performance of the project. A registered pledge on the project assets of SPV was also considered but was not possible because, further to Bulgarian property law, title on these assets was transferred by operation of law on attachment to the real estate property of the beneficiary. The structure of the contractual relationships with the suppliers and sub-contractors also prevented the SPV from demonstrating title on the project assets. Thus, the bank requested that the loan should also be mortgage-backed – it was supported by a mortgage on a piece of immovable property of wholly-controlled by the beneficiary company. This control caused bank supervision concerns as the property to be mortgaged was insured with an insurer wholly controlled by the beneficiary. This meant that the mortgage was not good security for reasons of system failure risk, and the controlled company group's rules did not allow a change of insurer. Thus, the facility had to be structured so that the borrowed amount would be used towards partial repayment of the debts already incurred by the supplier of the SPV, and this supplier agreed contractually to subordinate its claims to the SPV to the claims of the bank, in order to provide additional security.

This case study is based on a case that is not yet closed. The relatively stiff regulatory environment may invite further innovations in structuring of the financial and legal relationship. The key point is that within the existing legal framework (regulating only term bank loans and not allowing pure project financing), it is possible to develop structured finance models to suit project finance and similar instruments of financial engineering in Bulgaria.

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