
Project Finance in Central and Eastern Europe from a Lender's Perspective: Lessons Learned in Poland and Romania

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In 1993, the European Bank for Reconstruction and Development approved ninety-one investment projects. This article considers two of those projects, the Virolite Functional Polymers project in Romania and a Polish paper mill investment, Trebruk/Kostrzyn. In an effort to understand the legal and economic undercurrents that affect the transition to a market economy in the two countries, the author examines: the background of foreign investment in Romania and Poland; the differing levels of country risk facing investors and lenders and how these impact the structure of foreign investment and financing; and, finally, the different methods of investment structuring available to reduce project risk in both countries.

This article presents a comparative case study of two important emerging markets in Eastern and Central Europe. It attempts to draw broad conclusions regarding the particular legal and economic situations of the two countries, and how this affects their respective capacities to attract, secure, and reward foreign investment.

En 1993, la Banque européenne pour la reconstruction et le développement a approuvé quatre-vingt-onze projets d'investissement. Cet article s'intéresse à deux de ces projets, soit le *Virolite Functional Polymers* en Roumanie et le projet d'usine de pâtes et papiers en Pologne, appelé Trebruk/Kostrzyn. Afin de comprendre les courants légaux et économiques sous-jacents qui influencent la transition vers une économie de marché dans ces deux pays, l'auteur examine : les antécédents d'investissement étranger en Roumanie et en Pologne ; les différents niveaux de risque pour les investisseurs et les prêteurs et l'impact qu'ils ont sur la structure de financement et d'investissement internationale ; et, finalement, les diverses méthodes de structuration de l'investissement disponibles pour réduire le risque qu'entraîne un tel projet dans ces deux pays.

Cet article présente une étude comparée de l'émergence de deux marchés importants en Europe de l'Est et en Europe centrale. Il tente de dégager des conclusions générales sur la situation économique et légale particulière de ces deux pays et la manière dont elle affecte leur capacité respective d'attirer, de conserver, et de rétribuer l'investissement étranger.

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Introduction

The European Bank for Reconstruction and Development ("E.B.R.D." or "Bank") approved ninety-one investment projects in 1993.¹ The author, as a lawyer in the Office of General Counsel for the Bank, was involved in eight of these projects including three in Poland and three in Romania. The general lessons learned in two of these investments² provide an interesting comparison between the legal theory and the practice of project finance from a lender's perspective in two distinct, nascent markets within the general, emerging markets of Central and Eastern Europe. This Note does not aim to provide an in-depth analysis of the two projects;³ rather, it attempts to make some general observations about the economic and legal backgrounds of the countries in which these projects are situated, and it explores how these foundations affect the structure and implementation of such projects.

I. Romania and Poland: The Background for Foreign Investment

Romania and Poland are at different stages of transition to a market economy. Poland — along with Hungary and the Czech Republic — is more advanced in its move to capitalism and receives large amounts of foreign direct investment; while in Romania — like Bulgaria and Slovakia — reform is moving at a slower pace, and foreign investment remains more limited.

Romania has a diversified industrial and agricultural base, a skilled work force, and important natural resources. The total level of foreign investment in Romania remains modest, however, relative to the size and potential of the economy. Following three years of decline, its economy grew modestly in 1993 with a one percent increase in G.D.P.⁴ This was due to tighter monetary policy and the resulting progress toward positive interest rates, a reduction in inflation, and elimination of price subsidies. However, privatisation continues to advance slowly. Romania must still meet the challenges of reducing its substantial public sector, stimulating foreign investment, and developing a more flexible legal framework for private-sector development.

Poland had the largest number of E.B.R.D. investments in 1993. G.D.P. growth is strong, with the private sector already representing almost half of G.D.P.⁵ The le-

¹ See European Bank for Reconstruction and Development, *Annual Report 1993* (London: E.B.R.D., 1994) at 7 [hereinafter E.B.R.D. *Annual Report*].

² The Romanian project was an ECU 35,000,000 chemical plant, Virolite Functional Polymers ("Virolite") (see *ibid.* at 65); the Polish investment was an ECU 51,000,000 paper mill, Trebruk/Kostrzyn ("Trebruk") (see *ibid.* at 67).

³ Moreover, confidentiality requirements would prohibit an extensive analysis of these projects.

⁴ See President's Report and Recommendation to the Strategy for Romania, BDS/RO/94-1 (Final) (27 May 1994) [extracts are on file with the author]. The distribution of this document is restricted to the Directors and Alternate Directors of the E.B.R.D.

⁵ See President's Report and Recommendation to the Strategy for Poland, BDS/PO/94-1 (Final) (13

gal framework for a market economy is substantially in place, privatisation has been moving forward quickly, and foreign direct investment has increased significantly, reaching US 350 million dollars in 1993.

II. Structuring the Investment Based on Relative Country Risk

The view of foreign investors and project lenders regarding relative country risk affects the basic structure of project investment and its financing. The Virolite and Trebruk projects were structured differently due, in large part, to perceived levels of risk.

A. *Structure of Foreign Investment*

The Romanian market is less developed and is perceived by foreign investors as more unstable. As a result, the foreign sponsor in the Virolite transaction sought a joint venture with an established Romanian industrial partner operating in a similar field. The advantages to this strategy are numerous: a local partner can facilitate relations with regional and national authorities; it can also act as an additional source of financing and equipment; and if, as in this case, the local partner is also a chemical company which is an established industrial entity, then it can provide access to a supply of raw materials and energy. There are, of course, drawbacks to a joint venture as these operations require sharing of management and profit.

The borrower in the Virolite project was, thus, initially conceived of as a special-purpose, joint-stock company organised under Romanian law and capitalised by cash and in-kind contributions. The Romanian partner would contribute land and equipment on the site of its existing operation. The foreign investor would provide technical expertise, management skills, and an off-take agreement for the product. Both parties also subscribed in cash for a certain number of shares. The E.B.R.D. would, in turn, contribute limited-recourse, long-term debt financing.

It soon became apparent that the Romanian partner would be unable to provide its stipulated cash contribution because of the difficult economic situation in Romania. Ultimately, the E.B.R.D. was asked to purchase shares in the joint venture in order to compensate for the Romanian shortfall. The Bank, thus, became an equity investor and lender, and the initial investors gained not only a senior creditor but a significant minority shareholder.

The Bank's equity stake was structured as bridge financing under which the industrial investors were given a call option on the Bank's shares during the first seven years of the investment. Priority was given to the Romanian partner in the hope that, given time, it would be able to purchase the Bank's shares. Beginning in the seventh year, the Bank negotiated a put option of its shares to the joint venture

(to avoid dilution of the other investors), since the Bank's founding charter requires that it recycle its investments.⁶

The Trebruk project in Poland, on the other hand, did not involve a domestic partner. A Swedish paper manufacturer, with co-investment by Nordic institutional investors, purchased, through a privatisation auction, one-hundred percent of a financially-troubled and environmentally-unsound Polish pulp and paper mill. The privatised entity was then restructured with the closure of the polluting pulp mill, the introduction of Western technology for the expansion of fine-paper production, and the renegotiation (including write-offs) of existing enterprise debt.

B. Structure of the Financing

The relative risk of project finance lending in the Polish and Romanian markets was also reflected in the Bank's ability to attract other lenders to the projects. In Virolite, the E.B.R.D. was only able to interest the Overseas Private Investment Corporation ("O.P.I.C."), a United States government agency, to co-finance the loan to the Romanian joint venture. This investment, O.P.I.C.'s first in Romania, was made possible because the Western investor was an American entity.

In the Trebruk project, the E.B.R.D. structured its financing to include the participation of two international commercial banks in its own loan and a parallel loan from a syndicate of Polish commercial banks. The co-lending by local Polish banks provided further confirmation of both the advanced economic climate of the country and the soundness of its financial sector. This is not to say, however, that foreign investors and banks see Poland as an investment without risk.

In both the Polish and Romanian projects, the presence of an international financial institution ("I.F.I."), such as the E.B.R.D., acted as the catalyst for the participation of the foreign investor and financial institutions. As an international organisation linked by a multilateral, international convention⁷ and practice⁸ to its countries of operation, the Bank will take the, so-called, "political risk" of investing in an emerging market. The foreign investor and other participating lenders derive comfort from the E.B.R.D.'s special status *vis-à-vis* the country receiving the in-

⁶ See *Agreement Establishing the European Bank for Reconstruction and Development*, 29 May 1990, 29 I.L.M. 1077 at art. 13(x) [hereinafter E.B.R.D. Agreement].

⁷ The E.B.R.D. Agreement is a treaty binding on its shareholders, which are member States and international organisations (see: D. Peel, "Developing a New E.B.R.D. Product: A Case Study on Interpreting the E.B.R.D. Agreement", in this issue; also, see generally, I.F.I. Shihata, *The European Bank for Reconstruction and Development: A Comparative Analysis of the Constituent Agreement* (London: Graham & Trotman, 1990)).

⁸ The E.B.R.D., like the World Bank, the International Finance Corporation, and other regional development banks, enjoys, so-called, "preferred creditor status" under which its investments are, by international financial practice, free from rescheduling, moratorium, and foreign exchange restrictions (see M.H. Hurlock, "New Approaches to Economic Development: The World Bank, the EBRD, and the Negative Pledge Clause" (1994) 35 Harv. Int'l L.J. 345 at 365).

vestment. It is also felt that the risk of expropriation or nationalisation of the local entity or its assets is reduced by Bank involvement. Furthermore, undue interference by the state in the lawful generation of profit, both for repayment of the Bank's loan and the project's overall profitability, is apt to trigger possible sanctions, such as suspension or termination of that country's access to Bank resources and cross-default under E.B.R.D. and other I.F.I. financing.

Political risk is reduced by Bank involvement in the project or, as in the case of the Virolite transaction, is further reduced by the foreign sponsor's purchase of political-risk insurance which is offered by government agencies, such as O.P.I.C., to cover specified risks, including total expropriation or civil war. Investors and lenders are, therefore, free to make investment decisions based solely on "project risk" — a project's ability to produce revenues to repay debt and provide shareholder return on investment.

III. Structuring the Investment to Reduce Project Risk

Foreign investors and lenders each use various means to reduce project risk.

A. *The Foreign Investor*

For the foreign investor, reduction of project risk involves taking full advantage of various incentives offered by states to attract foreign investment. Both Romania and Poland offer similar advantages, such as tax holidays, exemptions from import duties for in-kind support (including plant and equipment contributions to the capital of the local company), guarantees on access to foreign exchange, and the ability to repatriate profits.

Foreign investors may also wish to mitigate the risks of devaluation and expropriation by holding hard currency in either domestic or foreign accounts. It is interesting to note that in the more developed economy of Poland, all companies, including those with foreign participation, can establish and hold *only* local-currency accounts with local banks. Foreign-currency accounts in Poland or abroad require National Bank approval, which is rarely granted.

In Romania, on the other hand, where the local currency has been in constant devaluation, foreign investors may retain their hard-currency capital contributions in foreign-denominated bank accounts, while companies that export for hard currency can retain such earnings to purchase imports. Since foreign investment is still limited in Romania, a major foreign investor is probably better able to seek and receive one-time government benefits outside the general regime offered to all foreign investors, such as increased tax and duty exemptions and approval for off-shore bank accounts.

B. The Lenders

Project finance is, in effect, limited-recourse lending. In other words, after physical completion of the project and commencement of production, the lenders must look to the project itself for financial return and not to the continued backing of the sponsors.

1. Pre-Project Completion Recourse

In both the Trebruk and Virolite projects, the E.B.R.D. entered into a form of Project Completion Agreement with the respective foreign sponsors. Under such agreements, the foreign sponsor is required to provide additional funds by way of subordinated debt or equity where, in the opinion of the Bank, such funds are required to achieve physical and operational completion of the project. The sponsor is, thereby, responsible to meet cost overruns and other contingencies in the project's financing plan. Furthermore, until completion the sponsor is liable for the financial obligations of the borrower under the Bank's loan.

Many sponsors consider these obligations to be harsh, but the Bank and other project-finance lenders assume the project risk based on a financing plan prepared by the sponsors. When the project facilities are completed and operating, the sponsor's obligations are terminated and the lenders may look only to project revenues and, ultimately, to security.

2. Post-Completion Recourse: Security

The founding charter of the E.B.R.D. requires that it operate in accordance with sound banking principles.⁹ As a prudent lender the Bank, thus, seeks a full security package to protect its investments. Such a package would ideally include a mortgage over real property (land and buildings), a pledge of equipment, inventory, receivables, intangibles (patents and trademarks), insurance proceeds, and bank accounts, as well as a pledge over the shares of the project company held by the sponsors. This presents a challenge, however, given the legal environments of the countries in which the Bank operates. Secured lending in the E.B.R.D.'s countries of operations, therefore, operates on a "best efforts" basis: the security package is structured so as to provide maximum protection except where limited by a country's public policy or by possible interference with operations of the borrower.¹⁰

In both the Trebruk and Virolite transactions the Bank and its co-lenders were able to assume, with varying degrees of satisfaction, a relatively complete security package. Not surprisingly, given the higher level of foreign investment and of project lending in Poland, the Trebruk package is a result of established — yet, judi-

⁹ E.B.R.D. Agreement, *supra* note 6 at art. 13(i).

¹⁰ For example, a possessory lien over equipment would provide excellent security but would prevent the company from operating.

cially untested — market practice. A mortgage over real property may be obtained by a relatively simple notarial act and entry in a local registry.¹¹ Under the *Polish Civil Code*,¹² only local Polish banks may take a non-possessory pledge over moveable property.¹³ Non-Polish bank lenders must use “transfer of moveables” agreements with the borrower, under which title is transferred to the lenders while the borrower retains possession. This is combined with physical labelling of the moveable property to provide notice to third parties. The *Polish Civil Code* also allows a pledge by written contract and notice of other rights, such as receivables, shares, insurance proceeds, and intangibles.¹⁴ With the exception of shares, which can easily be perfected by delivery of the certificates, the Bank relies on assignment agreements under which the rights are assigned to the Bank up to the amount of the secured debt with the contractual remedy upon default to apply proceeds received to the satisfaction of the unpaid debt.

The final obstacle to secured lending by the E.B.R.D. and foreign banks in Poland is the *Code of Civil Procedure*,¹⁵ under which in enforcement proceedings unsecured debt to local banks ranks ahead of debt secured by mortgage or pledge to other creditors. In the Trebruk transaction, this was remedied by a contract for security sharing among the local and foreign banks forming the lenders’ syndicate. Where local banks do not form part of the financing syndicate (for example, banks providing short-term, working-capital credit), then foreign bank lenders must either insist upon subordination agreements with such local banks or accept their priority.

Romanian security law and practice is extremely limited, and even the question of private ownership of land is controversial. The *Romanian Civil Code*,¹⁶ however, which is based on the *Napoleonic Code*, does contain provisions on mortgages and pledges.¹⁷

The Virolite project highlighted a major concern for foreign investors and lenders in Romania: while land may now be held privately by Romanian natural and legal persons, it is very difficult for them to obtain proof of title. Furthermore, non-Romanians are prohibited from owning land. However, there is apparently no prohibition on a Romanian entity, involved in a joint venture, such as the Virolite project, from owning land. A Romanian partner may also contribute land ownership rights to the capital of a Romanian entity as an in-kind contribution.

In the Virolite project, the Romanian partner is, at the date of this publication, still going through the process of obtaining title to the land that forms part of its

¹¹ *Law on Land Register and Mortgages* (6 July 1992), Journal of Laws N° 19, Item 147 (Pol.).

¹² (23 April 1964), Journal of Laws N° 16, Item 93 [hereinafter *Polish Civil Code*].

¹³ See *ibid.* at art. 308, para. 1.

¹⁴ See *ibid.* at art. 327.

¹⁵ (17 November 1965), Journal of Laws N° 43, Item 296, art. 1025.

¹⁶ (1 December 1865) [hereinafter *Romanian Civil Code*].

¹⁷ See *ibid.* at arts. 1769-779 (on mortgages), 1685-693 (on “*nantissement*” and possessory pledge).

existing plant, and that it intends to contribute to the joint venture. Assuming title is secured, the joint venture (with majority foreign participation) must then attempt to register this title. Only then can the Bank seek to obtain a mortgage on the property. Should the Bank wish to enforce its mortgage through judicial sale, it would likely have to form a Romanian company in order to hold the property.

The Bank has obtained a pledge on the shares of the borrower. Apparently, Romanian law does not recognise the concept of a pledge on bank accounts; the Bank must, therefore, rely on access to any existing foreign bank accounts that would be secured under foreign law. Finally, in an effort to anticipate the development of Romanian security practice, the Bank has relied on current French practice, which has developed to deal with a civil code substantially similar to that of Romania and which has evolved to meet the demands of modern secured lending. Thus, where security provisions are lacking in the *Romanian Civil Code*, as in a pledge of moveables/accounts receivable or insurance proceeds, the Bank may seek to arrive at similar results using non-security devices, such as call options on the assets and *délégation de paiements* for insurance.

As in the case of Poland, the security package available to the E.B.R.D. in Romania is innovative but un-tested in court. Some comfort may be derived, however, from the similar codal provisions and closer links between France and Romania through which Romanian judges might be positively influenced by French developments.

Conclusion

While the above discussion of project-finance problems and solutions, in two emerging markets at different stages of transition to a market economy, provides various points of similarity and divergence, it must be emphasised that this analysis is a snapshot. Both countries continue to develop to meet the challenges of transition. Also, when compared with the difficulties facing investors and lenders in less developed economies, such as the C.I.S.,¹⁸ which are also included in the E.B.R.D.'s sphere of operations, the similarities and accomplishments outweigh the problems.

The E.B.R.D. will continue to encourage this transition through ongoing investment and law-reform initiatives,¹⁹ but the best evidence of success will be stable, increased foreign investment and project finance.

¹⁸ See D. Gogek, "Russian Company Law Reform: Have Flawed Laws Impeded the Transition to a Market Economy?", in this issue.

¹⁹ See e.g., European Bank for Reconstruction and Development, *Model Law on Secured Transactions* (London: E.B.R.D., 1994).