Article Title: ARCHIVE | Criteria | Corporates | General: Legal Criteria For Rating PRC Project Financings Data: (EDITOR'S NOTE: — This criteria article is no longer current.) Over the past several months, Standard & Poor's has been asked to rate a number of projects located in the People's Republic of China. As in other countries, "project financing" transactions in China involve capital-intensive facilities such as electrical generating stations, refineries, toll roads, and water, sewage, and industrial plants. These transactions are based on secured loans: Assets are pledged to secure advances from investors for construction or refinancing the project. Investors look to revenues created by either the sale of the project's output or, in the case of static projects such as toll-roads, user fees to repay the loan. ADMINISTRATIVE AND LEGAL BACKGROUND The history of government administration in China is fundamental to the current legal process. In Imperial China, the "rule of law," as the phrase is commonly understood today, was nonexistent. The idea of separate executive, legislative, and judicial branches was similarly alien. With the establishment of the People's Republic of China in 1949, after years of war and unrest, and with the increasing dominance of the idiosyncratic Mao Zedong, the fabric of law and commercial practice deteriorated even further. Even the notions of socialist legality developed in the Soviet bloc were spurned in favor of the "leadership of the masses". In reality, party leadership made broad policies that local cadres were expected to follow. These policies often were vague, and in the absence of firm direction from party leadership, local officials exercised considerable discretion. As virtually all enterprises were the "property of the people," an independent judiciary was hardly necessary to resolve commercial disputes. Disputes were simply referred up the administrative chain for adjudication and decision. In the absence of normal margins of reference such as "ordinary business practice" or commercial law, disputes were resolved primarily by satisfying extralegal expedients. As China emerged from the Maoist period, it lacked the traditions, laws, and mechanisms to support the "rule of law." Instead, it was burdened with a system that featured: A highly centralized political authority formulated in indefinite terms and subject to broad interpretation by state policymakers. A lack of distinction between administrative directives and formally enacted laws. "Laws" were simply expressions of state authority that could be overridden by administrative decisions or left unenforced. A judiciary that saw itself as a protector of state interests rather than an independent arbiter of disputes. The present-day structure of government and the traditions of law and administration in China breed considerable difficulties and inconsistencies, especially in commerce. Government agencies often are under the policy guidance of a central government ministry, but also answer to provincial or municipal authority. Without clear delineation of authority or detailed legal and procedural substance, these multiple reporting relationships complicate decision-making. They also lead to inconsistent administration and practice, reflecting the competing influence of supervisory institutions and the interests of various decision-making officials. STANDARD & POOR'S RATING APPROACH IN CHINA China's political and legal systems require Standard & Poor's to devise a different approach in assessing the legal aspects of rating China-based projects. Standard & Poor's rating approach in China resembles those it has used to rate projects in other developing countries, adapted to local legal and political realities. An Standard & Poor's rating is designed as a statistical constant; it reflects the degree of legal and analytical risk, regardless of the transaction being rated. While the precise circumstances of financings may differ, Standard & Poor's analyzes each transaction, weighs the results, and summarizes the default risk. Standard & Poor's considers the strengths and weaknesses of different legal regimes in assessing cash flow risks. In assessing a project, Standard & Poor's considers a number of factors that may be roughly categorized as either "analytical" (including the source, nature, and extent of cash flow, debt-service coverage ratios, and numerous other economic, political, and social factors) or "legal" (including the obligation to repay, the ability of the documentation to safeguard cash flow, and a consideration of the legal doctrines and regimes that might affect the transaction). Standard & Poor's legal analysis: Attempts to determine the nature of the transaction and whether the papers properly reflect this agreement, Looks to the efficacy of the transaction's structure in determining whether the structure properly insulates cash flow from the effects of insolvency or other contingencies that could affect payment, Seeks to determine if collateral is sufficiently pledged to the indenture trustee for the benefit of bondholders, and Evaluates the transaction's compliance with applicable law, as understood by Standard & Poor's. If the rating were prejudiced by any of these factors, Standard & Poor's would explain to the issuer how the structural or legal risk inherent in that factor affects the rating. Standard & Poor's legal criteria are evolving for China-based transactions. These criteria reflect both the experience and understanding of project risk developed by Standard & Poor's global network and the criteria developed for the assessment of sovereign and subsovereign debt of China and its various agencies and enterprises. LEGAL CRITERIA CONCERNS Enforceability of contracts and the approval process. Compliance with government approval is important in China-based transactions. Standard & Poor's is unaware of any successful lawsuit brought by a foreigner over alleged breach of contract in China. Standard & Poor's assumes that enforcing contracts in China will be a protracted process with haphazard results at best, at least in the near term. To compensate for this organic weakness of China's legal system, Standard & Poor's will rate China-based transactions primarily on the basis of their economic attractiveness, and also will note whether the transaction appears to comply with applicable law. This level of compliance is measured by determining the nature of the legal and administrative approvals pertaining to the transaction, and the levels of authority required to pass on these approvals. In effect, Standard & Poor's looks at transaction documents as agreements not only between the parties listed on the cover page but with the mostly invisible but ever-present third party--the government. China's legal system has evolved in isolation from the rest of the commercial world. In the past few years, China appears to have taken the first steps toward implementing commercially oriented laws. However, in terms of enforcement of agreements, predictability of outcome of the judicial process, and judicial independence from the government, China's legal system lags considerably behind that of other countries. Standard & Poor's has adjusted its criteria to account for the difficulty or impossibility of proceeding to a rapid and predictable resolution of a dispute under China's judicial or dispute resolution process. From the analytical standpoint, Standard & Poor's emphasizes the supply and demand fundamentals of a project in assessing the capacity of the issuer and the sovereign to continue to pay, and to continue to permit to be paid, debt-service payments on the rated transaction. From a legal perspective, Standard & Poor's seeks to confirm that key policymaking and administrative groups are aware of and support the project. This twofold approach seeks to identify and analyze the various consents and approvals needed to bring the project into compliance with the law. The premise underlying these approaches is that if the need for the project has been sufficiently demonstrated throughout the term of the rated debt, and the project at the outset has met all applicable legal requirements, virtually all of the complications that typically threaten the full and timely payment of principal and interest have been dealt with. Standard & Poor's believes that this is a viable approach for rating projects in China: compared to governments in most countries ruled on the basis of the doctrine of separation of powers, the unitary government of China has considerably more sway in determining whether local entities will, absent economic considerations affecting the core business of the issuer, continue to allow debt-service payments. By giving appropriate emphasis to the credit policy and legal considerations that make the transaction economic and practical, Standard & Poor's seeks to determine if the interests of the issuer and the sovereign are best served by ensuring that the project will continue to operate and that, as a consequence, debt-service payments will continue to flow to noteholders both in and outside of China. Standard & Poor's legal criteria for rating China-based transactions are best shown by example. In a typical concession-type transaction, in exchange for a lump sum of proceeds raised through an issuance of notes by an offshore issuer, a China-based operating entity or its controlling shareholder, parent, or supervisory party grants a concession to a Sino-foreign joint venture. The joint venture arranges for the operation and management of the concession by the operating entity and its related corporate or governmental entities. The joint venture itself is controlled by the offshore issuer and by a local or provincial governmental entity. Note proceeds are usually used by the governmental entity to finance new infrastructure construction. The operating entity manages the concession and arranges (after deducting appropriate operating and management expenses) for the transfer of concession revenues to an onshore account held in the name of the joint venture. Project revenues held onshore in local currency (Renmimbi) accounts are exchanged for U.S. dollars and transferred to the offshore indenture trust or paying agent for application to noteholders. In transactions of this sort, Standard & Poor's will study the approval process from the perspective of the operating entity, the joint venture, and the transaction as a whole. OPERATING ENTITY APPROVALS In the context of a transaction similar to the foregoing, Standard & Poor's will require evidence of the approval of all appropriate governmental entities regarding the establishment and operation of those entities whose core business is the source of the cash flow for the transaction. Regardless of the nature or the ownership of the entity, Standard & Poor's will seek assurance that the entity has been properly established under Chinese law, and that its business activities have been properly approved. As for the establishment of the entity, Standard & Poor's will, at a minimum, require evidence to confirm that: 1) The relevant provincial planning commission or other entity has authorized the organization and existence of the entity; 2) COFTEC/MOFTEC approvals for the entity have been secured; 3) The business license has been properly issued; 4) The entity complies with all capital ratio tests and, for aggregation purposes, strictures relating to its PRC domicile have been addressed; and 5) The representative of the operating entity charged with the approval and signature of the transaction has been duly authorized to act. Standard & Poor's will also seek assurance of the legal capacity of the entity's operations under Chinese law. Thus, Standard & Poor's will, at a minimum, require evidence that: 6) The operating entity's corporate documentation is sufficient to permit it to run its business as contemplated; 7) The operating license is valid and has not been suspended or withdrawn; 8) The principal operating and financing documents have been approved by the operating entity and by all relevant levels of governmental bureaucracy; 9) The operating entity has secured all applicable import licenses for foreign technology and equipment; and 10) All environmental approvals have been secured. JOINT VENTURE APPROVALS Standard & Poor's requires that evidence of each of the approvals described in items one through 10 above should also be provided with respect to the joint venture vehicle, and to the extent feasible, to the Chinese government venturer or any other China partners. In addition, Standard & Poor's will require evidence that: 11) The joint venture has secured all foreign currency conversion and guaranty approvals from the State Administration for Exchange Control (SAEC) and that the supervising entity of the SAEC branch granting the final approval confirms that the granting branch has the ultimate approval power; 12) The payment obligations of the joint venture have been properly registered; 13) SAEC approvals for overseas remittances have been secured; 14) The joint venture has access to swap centers; 15) The joint venture has secured all approvals necessary to adjust tariffs; and 16) The State Assets Control Commission has approved the transaction. In addition to the routine legal opinions issued at closing, Standard & Poor's will require counsel to opine on the specific legal approvals required to consummate the transaction and to confirm that no other additional approvals will be required. It should also be noted that these requirements will vary according to the transaction and Standard & Poor's requirements are subject to change depending on the facts and circumstances of each case. DOCUMENTARY PROFILE In 1949, when China effectively abolished the law of contract, it got rid of certain other things as well: doctrines of contract interpretation, which added a degree of predictability and assurance to commercial dealings; methods of contract enforcement, which compelled parties to live up to their word; and most fundamentally, the art of writing contracts. The quelling of commercial legal practice in the Maoist and post-Maoist years has had a profound and unsettling effect on the quality of much of the legal documentation originating in China. One particular area of concern is the general failure of much documentation to permit the reader to "follow the cash," so that at every point in the transaction, there is a clear statement of where the payment came from, where it is, where it is going, and when this will all happen. Standard & Poor's must be able to determine when taxes and other governmental impositions are due, when service and management charges are payable, and the timing and extent of all other drains on cash flow. Standard & Poor's believes that, as a legal and business matter, cash flow is best not treated as a matter of eventuality or chance as the rating may suffer in consequence. Standard & Poor's is concerned with how the documents fit together. In one recent transaction, Standard & Poor's noted that the duties of the parties under the power purchase agreement contradicted their duties under the joint venture agreement. Responsibility for these shortcomings is not the issuer's alone. Investment banks and law firms also are involved by their participation in the transaction. Standard & Poor's expects that offshore investment banks and law firms will ensure that transaction and financing documents for rated transactions will approach the standards of the papers seen in other sophisticated Asian financings. FINANCING DOCUMENTS Standard & Poor's looks to the financing documents to interweave with the project documents and to pledge more effectively the transaction collateral to the indenture trustee as security for the payment of the notes. At present, China's laws do not truly recognize "security interests" in documents, accounts, and tangible and intangible personal property: "secured loans," as understood in the West, are problematic in China. While Standard & Poor's understands that progress is being made in this area, enforceability against collateral located in China will be subject to sovereign constraints that may--or may not--evolve with a progressively more sophisticated legal code. When debt-service payments move from China to the offshore indenture trustee, Standard & Poor's requires that the indenture creates a security interest in the indenture trustee, and that security interest should be perfected and prioritized in favor of noteholders. While this requirement is consistent with Standard & Poor's criteria for other secured financings, the security interest will attach only to those funds and rights in the indenture trustee's possession. If debt-service transfers are blocked by China, the security interest will be nugatory. Standard & Poor's will require a legal opinion from transaction counsel to the effect that the indenture trustee enjoys a first perfected security interest in the collateral. For offshore transactions, Standard & Poor's will review the structural devices addressing the credit concerns arising out of the use of reserve funds and letters of credit. Standard & Poor's reviews the transaction documents to ensure that there are no contractual circumstances or structural features that would relieve the paying institution from its obligation. Before issuing a rating, Standard & Poor's will ensure that the transaction meets any applicable bankruptcy preference criteria. LEGAL OPINIONS Standard & Poor's often will retain legal counsel in Hong Kong familiar with China's laws, customs, and practices to ensure that our assumptions and conclusions leading to a rating are consistent with local laws and facts. Standard & Poor's also routinely seeks legal opinions from transaction counsel addressing the fundamental legal premises on which the legality of the transaction is based. These opinions are legal confirmation of Standard & Poor's understanding of the transaction. They also serve to assure Standard & Poor's and investors of the validity of the assumptions on which the rating is based.