Bankability of contractor performance security in Latin American construction projects

Delays in construction projects are common and even more so at the moment, and so the question of ensuring that there is a mechanism for the prompt payment of damages in the event of a contractual breach is arguably now more important than ever.

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When embarking on the construction of energy and infrastructure projects in Latin America, contractors are typically required to provide security to back their payment and performance obligations in the underlying construction or supply agreements.

The focus has traditionally been and remains on the liquidity of the instrument, but project owners and lenders are taking different approaches with respect to contractor performance security, as it is not always easy for a project owner to receive payment for damages or remedial work in the event of a contractor breach.

Irrevocable standby letters of credit tend to be the more liquid forms of performance security that contractors commonly provide to backstop their obligations. Depending on its conditions, a project owner as beneficiary under a letter of credit may simply need to deliver a formal notice to the issuing bank in order to receive payment.

As an alternative, contractors can provide parent guarantees or surety bonds, but these instruments typically require a more cumbersome process for project owners to receive payment or performance of the underlying contractual obligation.

Liquid forms of security

This is particularly important in Latin America, where security issued under local law, such as "fianzas" in Mexico or "seguros de caución" in Argentina, may not provide for payment on demand to the project owner as beneficiary. They may instead require legal action such as a final and binding judgment confirming the contractor's breach, or include conditions such as termination of the underlying agreement.

Although the advantages for project owners to require liquid forms of security such as letters of credit may be obvious, these instruments typically come with additional costs for project owners and risks for contractors. Contractors will include any costs of taking out performance security in the underlying contract price. These may be significant depending on the amount and term of the letter of credit.

Contractors may also not have sufficient lines of credit with their issuing banks to support substantial letter-of-credit capacity, in particular given the impact of COVID-19 on the balance sheets of many international contractors.

Contractor internal risk policies may also impose limitations on the amount and volume of letters of credit issued on a contractor's

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behalf. These cost and risk factors should all play into a project owner's decisions regarding adequate contractor performance security in a construction contract.

In addition, lenders may not have the same perspective as project owners in this respect, given the primary focus of a lender on price and time certainty during execution of the construction phase.

A liquid form of security, such as a letter of credit, provides leverage to ensure that contractors perform their obligations laid out in the underlying construction contract. Project owners and lenders may not necessarily agree that the additional cost of liquid security provides added or sufficient value to the project.

This has created a tension between project owners and international lenders in Latin American construction projects, particularly in projects that are more complex, in jurisdictions with greater political and legal instability, or where contractors have less experience with the applicable technology or doubts over credit standing.

International lender scrutiny

The importance of liquid security was recently highlighted in a particular case in Argentina after the country reopened to international project financing and the first wind projects were being rolled out. Although the chosen contractor had extensive experience building wind farms, international project lenders heavily scrutinized its security package.

This raises the question of whether project owners should incur additional cost for an instrument they may never use, particularly if they are working with leading international contractors or have previously successfully executed a project in Latin America.

The answer depends on many of the factors mentioned above. In any event, a liquid form of performance security tends to change the dynamic of the contractual relationship between the project owner and the contractors. This is particularly true for projects that experience delays, and which are disputed between the parties.

Contractors tend to feel more pressure to perform when a liquid form of security is on the line, as opposed to a parent guarantee or surety bond. International lenders will likely continue to analyze contractor security packages in Latin American construction projects in view of the added complexities that energy and infrastructure projects are currently facing for timely completion due to the COVID-19-related impact.

However, letters of credit do not represent the panacea for liquid performance security. In recent Mexican and other Latin American energy projects, contractors have successfully prevented or impeded draws on letters of credit by presenting requests for injunctions in the jurisdiction where the letter of credit was issued.

Letters of credit can often require a breach by a contractor under the construction contract as a condition to draw, for example citing delays "attributable to the contractor". In certain jurisdictions, courts or arbitral tribunals may look into the merits of the underlying breach that triggers the right to draw under the letter of credit.

If they find that the contractor did not breach the construction contract, they may issue an injunction to freeze the draw from the issuing bank's account located in its jurisdiction by determining that the project owner is not entitled to such draw on the letter of credit.

The financial and practical implications of adequately structuring contractor security packages can can have significant influence over the successful and timely completion of construction in the region, and the complexities behind building energy and infrastructure projects in Latin America will likely increase in years to come. This means the debate between project owners and lenders regarding contractor performance security will endure, and the question of "what is bankable?" in an international financing in Latin America will likely remain open.

> **"The financial and practical implications of adequately structuring contractor security packages can impact successful and timely completion of construction in the region**