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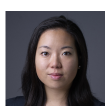
Limited Recourse Finance Series, Part 4: Other Common Issues in Limited Recourse Structures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In the final part of this four-part series, we explore some of the common issues that may arise in limited recourse structures, as well as ways to address or mitigate the risks and costs.

Intra-Group Transfers – Stamp Duty Land Tax (SDLT)

For some portfolio companies, one of the due diligence issues for the lender is to ask whether properties and/or companies were subject to intra-group transfers as a result of corporate restructure, or whether there are any plans to do so during the term of the loan. Although intra-group real estate transfers are generally not subject to UK stamp duty on the basis that SDLT intra-group relief applies[1], this relief would be subject to clawback where (among other things) the Transferee leaves the SDLT group within three years of the transfer of the property.[2]

From a lender's perspective, there are two methods in practice to address the risk of any SDLT relief being clawed back:

1. that there are adequate restrictions in the facility documentation to ensure that any restructuring, or any Obligor or member of the same tax group leaving the Borrower's SDLT group, is prohibited if such action would give rise to a withdrawal of SDLT group relief; and
2. any enforcement action which may constitute breaking up the SDLT group, and thereby triggering the SDLT clawback, should be considered carefully and adequate measures should be included to mitigate the risks and also the potential liability.

The clawback provisions of SDLT group relief are not mirrored in the stamp duty provisions applicable to intra-group share transfers, but the reliefs are broadly similar in other respects. Where partnership entities are involved in an SDLT group relief claim (whether the partnership interest is itself being transferred or there is a

partnership within the group), particular care needs to be taken to avoid the loss of intra-group relief which might jeopardize the economics of the limited recourse financing.

Tax Group Consolidation

It is common for group companies to form a corporation tax group in the UK. Tax grouping enables members in the same tax group to allocate gains and surrender losses between members of the group on a current-year basis. Although each member of the tax group is subject to its own primary corporation tax liabilities, where such tax liabilities are not paid by one particular member, it is then possible for HMRC to recover that tax as a secondary liability from another member of the group.

Given that the nature of limited recourse financing is to ensure all assets and liabilities are ring-fenced in the same borrowing group, the sponsor may therefore wish to ensure that the borrowing entities are separated from the rest of the group for tax-grouping purposes, so as to avoid any cross liabilities which may arise.

If, however, the financing group is part of a wider tax group, one of the liabilities that may require investigation by the lender is the possibility of unpaid liabilities from members of the group outside the ring-fenced security structure. The lender may wish to include covenants and other safeguards against this potential risk.

Shareholder Security – Some Common Considerations

As discussed in Part 3 of this series, it is often expected that the holding company of the SPV Borrower grant security over (i) the Borrower's shares and (ii) to the extent applicable, any shareholder debt. The security over these two assets is to ensure that, upon enforcement, the lender has an option to undertake a corporate sale of the Borrower, free from the subordinated sponsor debt.

From the sponsor's perspective, because the security is only provided for a very particular set of assets (shares of the Borrower SPV and related debt into such SPV), care must be taken to ensure the recourse to the shareholder is limited to these assets only, and not beyond. Therefore, the shareholder security is often one of the more negotiated documents.

Some of the provisions which may be negotiated include:

1. enforcement of the shareholder security should not trigger insolvency proceedings on the shareholder. This is often quite important where the shareholder is the holding company for multiple SPVs and intends to obtain separate limited recourse financing for other SPVs and other real estate projects;
2. restrictions on non-competition or ability to claim on the debt by the shareholder; however, the shareholder may wish to retain the ability to claim its debt upon the insolvency of the Borrower. It is often expected that the lender, being a first-ranking secured party, would want to dictate when and how enforcement may take place over the assets. With respect to the subordinated debt, the lender would require the debt to be fully subordinated at all times whilst the loan is outstanding and payments are only allowed in specific circumstances (usually if there is a surplus cash flow

after servicing the loan). Therefore, the lender would usually include a host of restrictions on the shareholder such as restricting its ability to make any claims on the debt or call in the debt, if such action is in competition with the interests of the lender. That said, if insolvency proceedings have been commenced with respect to the Borrower, the shareholder would want to make a claim on its debt to ensure its liabilities constitute part of the overall liabilities of the borrower in the insolvency proceedings.

Final Thoughts

Over the past few months in *REF News and Views*, we have discussed some of the key characteristics of limited recourse financing, which remains a common and preferred approach with respect to real estate financing in Europe. We also explored some of the common issues that may arise in these structures and also issues to be considered in taking security. We encourage our readers to keep this **four-part series** on-hand as a reference guide.

[1] Paragraph 1, Schedule 7, Finance Act 2003

[2] Paragraph 3, Schedule 7 of Finance Act 2003