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Limited Recourse Financing Series: The Need for Limited Recourse Structures

By **Livia Li**
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Limited recourse financing (also sometimes referred to as "non-recourse") is a very common structure adopted in real estate financing transactions in Europe. The principle around limited recourse financing is essentially ring-fencing the assets which are placed in security in favour of the Lender, segregated from assets that are outside of the transaction. The Lender will only have recourse to the assets subject to security, without any recourse (or limited recourse) to any asset outside of the secured assets, nor against any entity outside the Borrower/Obligor group. The Borrowing entity is usually set up as a special purpose vehicle ("SPV"), and all of the Borrower's assets (which include the underlying real property(ies), along with associated assets affecting the cash flow, such as leases, insurance contracts, etc.) are subject to security for the facility.

In this series of articles in *REF News and Views*, we will look at some of the key features in limited recourse financing structures, as well as some common issues that may arise, in the context of real estate financing in the European market.

What is limited recourse finance and why is it used in real estate financing transactions?

The key principle of limited recourse finance is to ensure that the security and claim with respect to the loan is limited to only a prescribed set of assets and against prescribed entities. It is often used in the context of real estate finance because the fundamental source of recovery for the lender is the underlying asset (*i.e.*, the real property) itself and the cash flow it generates. In contrast, corporate finance facilities look to the creditworthiness of the Borrower and the trading group and therefore would generally require full recourse to all of the group's assets.

Benefits of limited recourse structures

Limited recourse finance is preferred for Sponsors who often have multiple projects. Limited recourse structures would allow the Sponsor to ensure each project is completely segregated. Importantly, if the loan becomes a nonperforming loan and the Sponsor is of the view that the value of the asset has deteriorated to a point where it is no longer worth the investment, it is possible that the Sponsor could walk away without any further liability as the Lender takes over the asset.

From a Lender's perspective, limited recourse financing also provides certain benefits – namely, the pricing and the terms would be more tailored to the quality of the underlying asset and security in question, and the focus is on the lending to the one particular asset (or portfolio of assets). Lenders can also take comfort in the fact that its security and the vehicle it is funding would not be tainted by any other activities or portfolio holdings and liabilities outside the Obligor group. For this same reason, limited recourse financing is often used in leveraged facilities and project finance facilities.

Instances where limited recourse may not be appropriate

Given the premise of limited recourse financing relies on the fact that the Lender only has recourse to the ring-fenced assets, it goes without saying that in assessing the security pool, the value of the assets (and the cash flow associated with such assets) must be sufficient on its own to make whole the loan in the event of enforcement.

In addition, the quality of the asset and the cash flows are of particular significance, given this is the only route to enforcement. Assets that are not considered stable or do not have stable cash flows may not be suitable for this type of structure (as the Lender may require additional support). The most obvious example in this category would be construction facilities, where there are additional risks in the building process involved and the asset has yet to generate stable income streams. It is often required by the Lenders that, as part of the security package, a certain commitment from the Sponsor (whether this is a full recourse guarantee, or a commitment of a certain amount to cover costs and overruns) would be required until the asset is "stabilised" and generating a certain amount or predictable cash flow.

Sponsor guarantees or commitments for a certain set amount may also be required in hotel financing, where the cash flow is quite cyclical, and due to the nature of the property being a hotel, its value is highly dependent on the health of the hotel business. It is often the case that, even in a financing structure where the property and the business are sitting under separate entities, and the financing is only provided to the SPV which owns the property and relies on the cash flow from a pre-agreed intragroup lease on a set rent amount, the Lenders would nevertheless look at the operating company which operates the hotel and, in some cases, the Sponsor for additional collateral. For more discussions on structures of hotel financing, please refer to our hotel financing series.

In instances where the Lender requires additional guarantee or Sponsor commitment, the financing is often structured so that the terms of such guarantee (or sometimes, if guarantees cannot be provided, is structured as investment commitments) are limited to a specified amount and the recourse to the Sponsor is therefore limited to this agreed amount. In addition, sometimes the ability to claim could be limited for certain triggers only (*e.g.*, cost overruns in a construction facility) and not as a general guarantee or indemnity.

In Part Two of this series next month, we will look at common features of limited recourse structures.

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Limited Recourse Finance Series, Part 2: Structural Features

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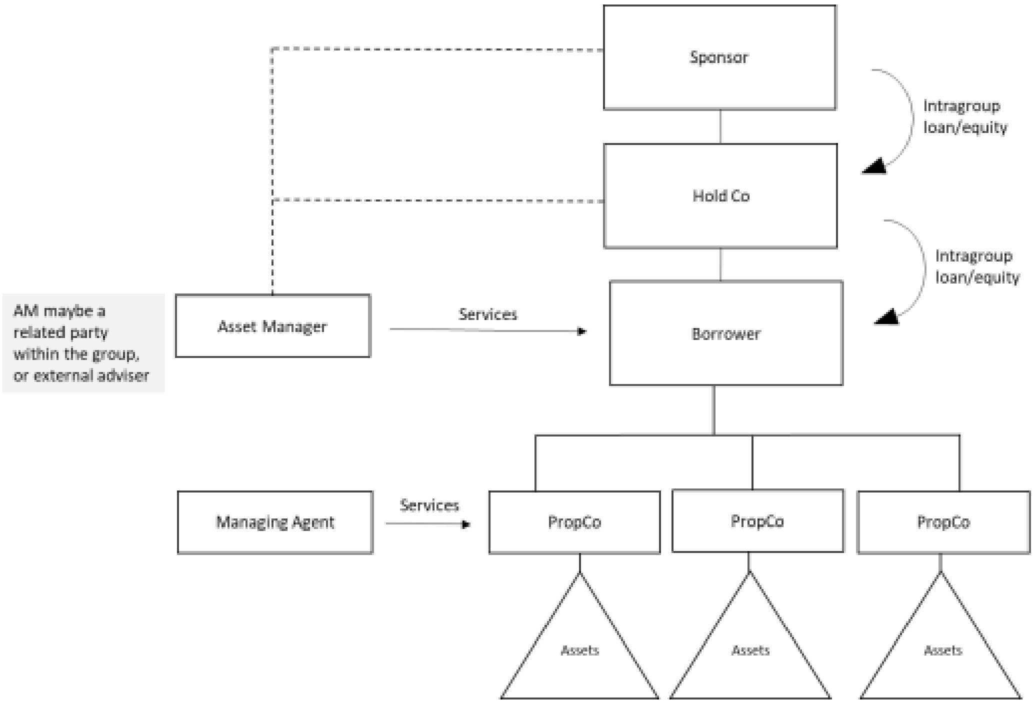
In Part Two of our series on limited recourse finance in the European real estate finance market, we look at the structural features.

Limited recourse structure can be achieved either structurally (which is the most common in real estate financing) or contractually.

Typical limited recourse borrowing structure

In a typical real estate financing facility, as illustrated in the diagram below, a special purpose vehicle ("SPV") is set up to be the Borrower and holds the underlying real estate asset; or, in the case of multiple properties, via subsidiary PropCos (each subsidiary again is set up as an SPV, only to hold the real estate asset). The Sponsor provides funding to the Borrower SPV either via an intragroup loan or by equity. A separate management company which is engaged to undertake the maintenance (and sometimes, manage the income such as rent and manage leases and tenants) provides services to the Borrower/PropCos with respect to the properties ("Property Manager"). Often, there is also an asset management company (generally an affiliate of the Sponsor) which provides investment and asset management advice to the Obligor Group with respect to the assets.



To achieve a limited recourse structure, only the Borrower SPV and its subsidiaries will grant security over its assets (which includes the underlying property). The Sponsor and Property Manager will not provide any security over its respective assets, save for assets/rights which are liabilities for the Obligor Group and therefore affect the solvency of the Obligor Group (examples include shareholder loans and claims under management contracts). This will be discussed in more detail in Part Three of this series next month.

Contractual terms to limit recourse – some limitations

Limited recourse can also be achieved contractually by having specific arrangements in place to ensure lenders only have limited claims over certain assets. However, this is often not the preferred approach, as enforcing contractual obligations in situations where the counterparty is not cooperative would require proceedings in court.

Furthermore, in *ARM Asset Backed Securities S.A. [2013] EWHC 3351 (Ch)*, where the sponsor granted a share charge over an SPV, although the share charge provided that recourse to the sponsor is strictly limited to the shares of the SPV whose shares are charged, it did not preclude the Sponsor from being found to be unable to pay its debts and therefore can be wound up. Therefore, this judgment further puts into doubt the effectiveness of limited recourse only via contractual terms.

Clear distinction on assets and liabilities in or out of ring-fenced group

Given the recourse for the lenders is limited to the assets in the security pool and the Obligor Group (which is ring-fenced from the rest of the sponsor group), when conducting due diligence and constructing the security package, additional care needs to be taken to ensure these assets, upon enforcement, will yield sufficient recovery. To this end, in addition to the structural requirements in having all the assets supporting the loan sitting within the ring-fenced structure (or can be easily severed upon enforcement), one other key consideration for lenders is to ensure that liabilities and claims against the ring-fenced group are either contained within the group (*i.e.*, intragroup liabilities) or, if such liabilities are outside of the group (most common example being sponsor debt), such liabilities can be severed in the same way upon enforcement. To the extent there are any liabilities outside of the group which pose as a threat to the lenders’ claim to the debt and/or the assets, such liabilities must be addressed adequately.

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Limited Recourse Finance Series, Part 3: Security Package and Considerations

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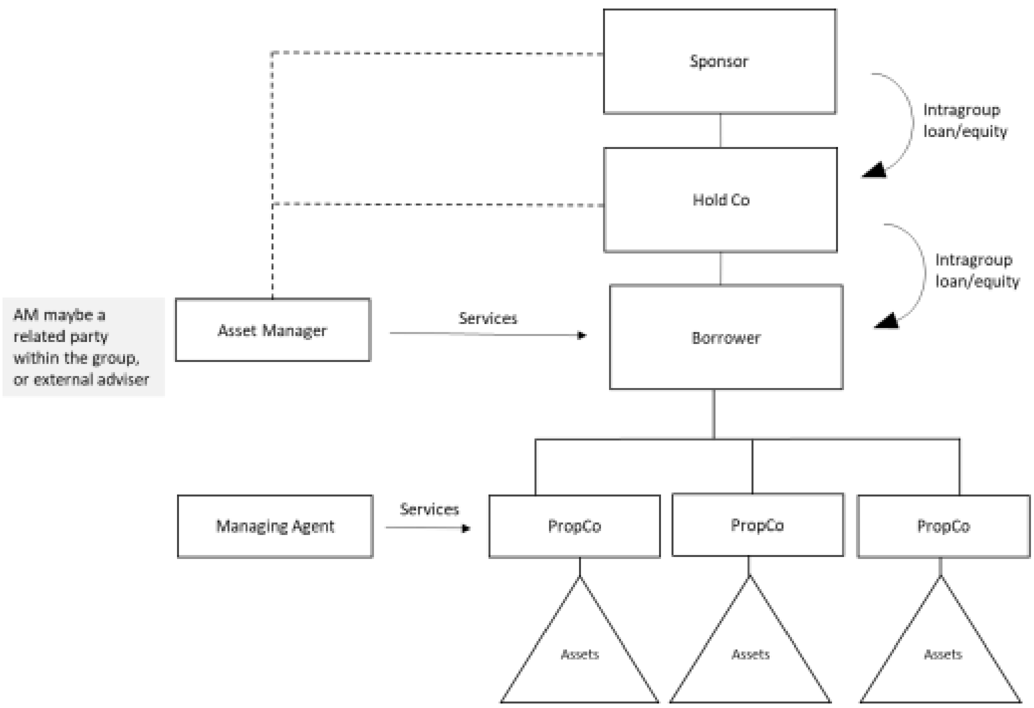
In this Part 3 of the limited recourse financing series, we discuss some common issues and considerations with respect to the security package in a typical limited recourse structure.

For a typical SPV structure (see diagram below):



The usual English law security package would include all asset security to be granted by all Obligors. The Obligors would include the SPV Borrower and, if the real estate is held by subsidiary PropCos, the shares of such PropCos and also all assets of such PropCos. This will include:

1. Real estate mortgage over the Properties.
2. Security over all bank accounts held by the Obligors. (This will also include the agreed control mechanisms. It is not unusual for certain bank accounts

to be subject to the control of the lenders, requiring co-signing authority/approval before any withdrawals.)
3. Security over insurances with respect to the Properties.
4. Assignment of key (if not all) contracts, including the leases.
5. Security over subordinated shareholder debt in the structure[1].

In addition to the security documents, the following documents are generally required:

1. To the extent there is a property manager managing the property, a duty of care agreement between the lender, the property manager and the borrower.
2. To the extent there is an asset manager, a duty of care agreement between the lender, the asset manager and the borrower.
3. Subordination agreement with respect to the shareholder debt.
4. To the extent there are any other key contracts which would affect the value of the income and/or the value of the property, additional documents which would provide the lender step-in rights (for example, if the property is a hotel and subject to a franchise or hotel management agreement with a hotel chain, a non-disturbance agreement).

In considering the security package, the ultimate question for a lender is how the security package should be structured to assist its exit strategy. Clearly, the cleanest, and possibly simplest, approach for a recovery strategy for lenders is to sell the property in an enforcement. Therefore, the approach taken in non-recourse/limited recourse real estate financing would often require security over all assets of the borrower SPV, and each intermediary holding company (if any) to the underlying asset, along with each asset that contributes to generating the cash flow to the property. To ensure the lender can sell off the entire package with relative ease, a share charge is often taken at the holding company level (over the shares of the Borrower SPV, and each of the entities that have property interest) to allow for a corporate sale.

To ensure the security package wouldn't breach the non-limited recourse structure, security granted by the holding company/sponsor (namely, the share charge and security over shareholder debt, if applicable) must include limited recourse language. The language would provide that the lender's recourse is only limited to the asset subject to security (*i.e.*, the said shares and/or shareholder debt), and beyond these assets, there is no further recourse to the sponsor in any way. Although the documentation seeks to achieve zero recourse/liability against the sponsor by limiting the lender's recourse only to the assets, the sponsor could, despite the provisions of the security documentation, still be liable. This is the case where there is misrepresentation or breach of covenant on the part of the sponsor involved, as the lender may look to general contractual remedies against the sponsor for breach of contract and seek damages from the sponsor. However, this is distinct to recoveries for the underlying debt owed by the SPV borrower.

Aside from taking security over all relevant assets and cash generating contracts, lenders would ensure that anything which gives rise to liability would be addressed. The types of liabilities can be broadly split into two categories:

- liabilities which are essential to continue the day-to-day running of the property, and

- liabilities which were sunk costs into the SPV vehicle/structure and which, if removed, would not affect the future cash flow generated by the property.

Liabilities in the first category would include the head lease (if the property is a leasehold), ongoing maintenance/property management contracts, and, in the case of hotels, the franchise agreement – all of which are essential, and the loss of such contracts and related liabilities would be detrimental to the value of the property.

Liabilities in the second category would include shareholder loans and other subordinated debt, and depending on the nature of the asset management contract and the services provided, if it is determined such services do not contribute to the value and/or cash flow generated by the property, the liabilities under such contracts. It is often the approach to ensure that liabilities classified in category two can be eliminated in enforcement so that the asset is presented in as attractive light as possible to potential buyers.

In Part 4 next month, we will discuss some of the common pitfalls with limited recourse financing structures.

[1] It is often the lenders' preferred approach to take security over the subordinated debt as it provides proprietary interest over the debt which makes it easier to discharge in an enforcement scenario. That said, in some circumstances where security cannot be provided over the subordinated debt, it is possible to agree to specific powers to write-off the subordinated debt in the subordination agreement. With this approach, the lenders will rely on its contractual rights under the subordination agreement.

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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

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