PiperAlderman

Article Information

Service: Banking & Finance, Corporate & Commercial Finance
Sector: Financial Services

Ring-fencing: The proper use of special purpose vehicles

A parent company will often establish a Special Purpose Vehicle (SPV) to reduce financial risks arising from certain assets, projects or acquisitions. SPV structures provide opportunities for corporations to limit their exposure to individual assets. An SPV will only be beneficial to a corporate group if the SPV structure is properly established at the creation of the group structure. This article will explore the use of SPVs, the advantages and shortcomings of SPVs, and the proper use of SPV structures.

What is an SPV?

An SPV is a separate legal entity that is formed to undertake a specific business purpose or activity. An SPV is created within a group of companies as a means to isolate certain risks associated with acquiring assets or ventures, often referred to as "ring-fencing". An SPV only holds project specific assets and liabilities as well as having its own legal status. The main advantages of SPVs include the isolation of risk and broader options when selling or managing the project asset.

Benefits of SPVs

There are various benefits of establishing an SPV structure, namely the following:

1. **Mitigation of risk** – Corporate groups can create an SPV as an "orphan company" to ring-fence risks to the SPV and its assets. In the event of default or insolvency, creditors can only claim against the assets of that particular SPV as it is a legal entity separate from the parent company and the wider group. This means that the parent company, other SPVs or assets within the group, are safeguarded from default risks and can continue to operate despite that non-performing SPV / asset. By creating SPVs, companies can isolate the financial and legal risks that may arise from projects, acquisitions or new ventures whilst protecting the parent company and the wider group.
2. **No security leakage** – By establishing an SPV where the loan and supporting securities are limited to the borrower and its assets, it ensures that there is no security leakage to the parent company, other SPVs or other assets in the group. This means that if an SPV defaults, only the assets secured by the lender, that is the SPV's assets, will be at risk / the subject of the enforcement of the lender's securities. The assets of the parent company or the wider group will be not be affected / contaminated.
3. **Reduced red tape** – SPVs are relatively cheap and easy to set up as there are minimal administrative processes required.
4. **Flexibility** – There is flexibility in adapting SPV structures in different jurisdictions, for different corporate structures and for various purposes.

Disadvantages of SPVs

The main disadvantages of establishing SPVs include:

1. **Reputation** – The default of an SPV and the underperformance of its assets may damage the reputation of the parent company / corporate group.
2. **Liquidity risk** – If an SPV is performing poorly, it may impact the parent company's access to the capital market on future transactions. Similarly, if an SPV's assets underperform, it may become difficult for the parent company to sell the asset back on the open market, creating a liquidity risk to the assets.

The Proper Use of an SPV Structure

If an SPV structure is not properly established, this may lead to the contamination of the existing corporate structure of the parent company and the wider group. A contaminated SPV structure often occurs when an SPV has a guarantee and indemnity (sometimes combined with other securities) from the parent company (sometimes in conjunction with a director guarantee, which poses other issues) to support its debt facility. In the event that the SPV defaults, it will be likely to trigger cross-defaults with other facilities that the parent company is involved in, and ultimately any enforcement against the parent company may result in defaults in all other facilities of the group creating a ripple effect and the ultimate demise of the group.

On a separate note, if a director provides a personal guarantee in support of any debt facility in the group, if the guarantee is enforced against that director and that director becomes bankrupt, that director will no longer be able to hold office in any company, unless they have been granted special leave by the court,[1] or until their bankruptcy status has been discharged, which is usually after 3 years. The removal of that bankrupt director may trigger a change in control event under any other facility that the director holds office and could potentially trigger defaults under the debt facilities for the balance of the group.

As an example, Smith's Real Estate Pty Ltd (**Smith's Real Estate**) (i.e. the parent company) wants to enter into a loan with ABC Bank. Smith's Real Estate sets up an SPV structure to ring-fence any financial risks that may arise from that loan. This loan arrangement is limited between Smith's Real Estate's SPV (**Smith's SPV**) and ABC Bank. This loan arrangement is secured by an asset of Smith's SPV which is a building on George Street. If Smith's SPV defaults, creditors will only be able to enforce against the building on George Street and that SPV. The other assets held by Smith's Real Estate including an office building in Circular Quay, a hotel in Bondi and a pub in Newtown, will not be affected and Smith's Real Estate can continue to operate as usual. As there is no guarantee from Smith's Real Estate or any personal guarantees from its officers, this is an example of a correctly established SPV structure which has isolated the group risk to that SPV and the assets of that SPV.

To avoid the risks (together with other risks) of contaminating the entire group following a default under a debt facility within the group, it is important to ensure that:

1. an SPV is set up correctly and ring-fenced from the group; and
2. no director guarantees or parent guarantees (or guarantees or securities from any member of the group) are provided in support of any other facilities within the group.

Summary

- An SPV is a separate legal entity that can be used to isolate financial risk;
- If a parent company properly establishes an SPV, and that SPV defaults on a loan, creditors will only have recourse to the assets of that SPV. The parent company and the wider group will not be affected and can continue to operate; and
- Disadvantages of creating an SPV include reputational and liquidity risks.

For further information relating to an SPV structure or adapting this within your own corporate structures, please contact Banking and Finance Partner, Greg Conomos.

[1] *Corporations Act 2001* (Cth) ss 206B(3) and 206G.