
Feeling the squeeze, Part 3: Ring-fencing for the protection of care sector borrowers in finance arrangements

Received: 18th April, 2008

Estelle Clarke

spent seven years working for Clifford Chance in London, principally as part of its prestigious banking team. Estelle joined Thomas Eggar LLP, one of the leading law firms in the south, as a partner on 1st May, 2008, having been a partner and head of banking at Lester Aldridge. During her time at Lester Aldridge, Estelle led a team specialising in care sector transactions, representing corporates, banks and financial institutions in matters including acquisitions, disposals and commercial funding arrangements. Estelle has an unusual insight into the care sector and is passionate about improving commercial arrangements within the sector without compromising its acute social responsibility. She believes that enhanced knowledge coupled with innovative financing techniques will provide a good foundation for the future evolution of business within the sector, even as the commercial and political climate changes.

Abstract

In Parts 1 and 2 of 'Feeling the squeeze' (*Journal of Care Services Management*, Vol. 2. No. 2 and Vol. 2. No. 3), the adverse impact of the 'credit squeeze' on care sector borrowers who have entered into or are entering into finance arrangements was examined. Ways of dealing with this impact were suggested. These included the use of innovative financing techniques that can 'rescue' care sector borrowers from feeling the worst of the squeeze. This paper moves on from a rescue approach to one of protection. To do this, the practicalities and benefits of using a 'ring-fenced' financing structure for the benefit of the care sector borrower in the current lending climate are explained and considered. The market conditions have not improved. What then is the outlook?

Keywords:

borrowing, ring-fence, security, lender, loan, forced sale, assets

OUTLOOK UPDATE: DARK CLOUDS CONTINUE TO GATHER¹

Given the outlook, should one be talking about 'feeling the squeeze' or 'fielding the crunch' when referring to the current credit crisis? A squeeze implies temporary pressure which, when relieved, will be followed by a bounce back to a previous position. A crunch carries implications of permanency — a crushing that cannot be recovered from. A crunch could be expected to cause scarring, as if a bite has been taken. Notably, the squeeze has been 'upgraded' by the

Estelle Clarke
Thomas Eggar LLP
Newbury House
20 Kings Road West
Newbury
Berkshire RG14 5XR, UK
Tel: +44 (0)870 160 1300
E-mail:
estelle.clarke@thomaseggar.com

**The care sector
borrower deserves
protection . . .**

financial press to a ‘crisis’, itself implying great difficulty and maybe even danger. This echoes the dark perception many have of the short-term future of the lending business.

It is difficult to think of a borrower that is more deserving of protection from permanent adverse consequences of unforgiving borrowing arrangements than the care sector borrower. This is because the beneficiaries of such protection will be not only the borrower but also those in the borrower’s care — one’s family and friends — whose lives, wellbeing and contentment depend on the consistent continuation of the services being provided to them. A disruption in the provision of care could be deeply and unnecessarily upsetting. It would be good if the human value of the care sector was put at the forefront of considerations and the care sector borrower benefited from the maximum possible protection against adversity that might be imposed through its lending arrangements — in short, if the care sector is cared for while it cares for others. This is the reason for this paper: to pass on to care sector borrowers information on the protective mechanism of ring-fencing so that an increased awareness can help to ‘roll out’ such measures into the care sector.

Squeeze or crunch, whichever is right, the prognosis is grim. Ring-fencing could be a key method of minimising scarring from a lender’s crunch.

WHAT IS THE PROTECTION ACTUALLY FOR?

Before proceeding to the nitty gritty of ring-fencing and the benefits it gives, please see below the disadvantages that borrowers are experiencing because of recent changes in the lending markets. These are the ‘headlining’ features:

**. . . against these key
features**

- cost of borrowing — up;
- loan to value (LTV)² — down;
- security cover required — up;
- terms — down.

What does all this mean?

- *Cost of borrowing*: Increasing borrowing costs are making debt positions more expensive for borrowers. While falling interest rates assist when passed on to the borrower, other factors affecting the cost of borrowing need to be considered, such as lenders’ margins which are moving outwards. The result may be that even if interest rates fall, the cost of borrowing overall increases.
- *LTV*: Changes in the domestic mortgage market, for example, withdrawal of 100 per cent loans and increasing deposit requirements for borrowing, are well publicised. Lenders are no longer prepared to make domestic mortgages available on a 100 per cent LTV ratio and are now insisting on deposits of 10, 20

Hardening LTV values

and 25 per cent being made available (a return to the ‘good old days’, some would say). The trend of hardening LTV ratios (ie a reduction in the amount of loan that is offered in proportion to an asset securing that loan) is present also in corporate borrowing arrangements. In these, LTV ratios are moving from ratios as generous as 80–85 per cent down to 60–70 per cent and this is within a more demanding general security cover requirement. This reflects lenders’ concern to be comfortable that, in the event of a default and a consequential demand for return of lent monies, they will be repaid even though property values are falling.

Harsher terms of borrowing

- *Terms for borrowers:* Terms are ‘down’ (meaning worse for borrowers) as lenders seek greater certainty and comfort in the detailed terms of their documents. This has been addressed previously³ and typically it is seen via a tougher stance on financial covenants, harsher restrictions on the borrower and tighter terms relating to security. Therefore, the borrower has to make more money to meet the more demanding covenants, in particular, those which encompass a comparison or ratio of borrowing costs to income and asset values.

Ring fencing can protect . . .

The above mean it is tougher for the borrower and that the borrower is at an increased risk of default. Ring-fencing is protection for this risk. It can be used, where appropriate, to maximise protection against the calamitous consequences of default of borrowing arrangements during these darkening times.⁴

. . . by keeping assets outside the security given to the lender

WHAT DOES RING-FENCING MEAN?

The term ring-fencing is derived from the literal ‘ring-fences’ put around stock on farms to confine the stock in their correct and allocated areas. The contemporary financial meaning — whereby something is separated for protection — is consistent with this original meaning. In this paper, ‘ring-fencing’ means protecting assets by keeping them outside the security provided to a lender by a borrower to secure funds the lender has lent to the borrower. (As previously noted,⁵ the security is provided to the lender. In the event that the lender terminates the loan, for example, because the borrower has defaulted, the lender may realise the secured assets and use the money generated by the process of realisation of the secured assets to pay off amounts owed to it by the borrower.) Therefore, ring-fencing is useful for the borrower that has more than one significant asset and/or consists of, or is a group that comprises, more than one legal entity.

WHAT DOES RING-FENCING DO?

In the event the lender ‘pulls the plug’, while the lender does have recourse to those assets and entities that have given it security, that same lender does not have access to the ring-fenced assets and businesses that are outside its relevant security. This is because

On default, ring-fenced assets are protected

they have been successfully ring-fenced: the ring-fenced assets and/or entities are protected from being caught by the lender's security and can carry on with business as usual despite difficulties being experienced by other parts of the business. It is important that, if a ring-fenced approach is agreed, this approach is followed through into all aspects of the lending documents so that, for example, a default under the loan will not then trigger other restrictions on the borrower in relation to the ring-fenced assets or business, such as restrictions in operations, acquisition disposals, consents being required for certain activities or provision of trading information.

Ring-fence when the lender has sufficient 'cover'

WHEN MIGHT RING-FENCING ASSETS OR PART OF A BUSINESS BE APPROPRIATE?

The simple answer is when there is enough security 'cover' for the lender to be happy to lend without recourse to all assets and all parts of the borrower's business, as well as its related corporate entities. As a general guide, *first*, consider the value of the security being given to the lender to support the funding arrangements. Ring-fencing is appropriate if there is leeway for assets or entities to be taken out of the security structure with the lender still being left with cover within the ratio the lender requires. If leeway is not present at the time of signing the documents, it may be in the future. This is because decreasing debt (as repayment occurs) and increasing property values (despite current conditions and cyclically this is expected) will improve LTV ratios. In such circumstances, it could be agreed (and written in the documentation) that once LTV ratios are being met within a certain specified ratio, the lender and borrower look at altering the security structure so that ring-fencing can be introduced latterly. Because care sector borrowing arrangements are often medium to long term, taking a long view in this way and agreeing the consideration of the introduction of ring-fencing at an appropriate juncture in the future could be strategically very important (please see further below).

Ask!

If it seems the lender has enough cover for ring-fencing to be feasible, the *second* stage is to *ask*. It is unlikely that a lender will offer a ring-fenced approach as (naturally enough) a lender will wish to have the maximum possible security cover for its lend. The old maxim applies — if one does not ask one will not get.

WHY IS RING-FENCING OF PARTICULAR IMPORTANCE FOR CARE SECTOR BORROWERS?

Ring-fencing is of particular importance because a care business often consists of more than one legal entity and/or asset and funding arrangements tend to be entered into for medium to long terms. This means that unlimited security arrangements put in place 'cut across' (and potentially 'crunch') all entities related to the borrower. Such arrangements can continue for many years according to the term of the arrangements.

If all entities within a care business and all assets in a care business are used to secure one borrowing arrangement, the borrower effectively has tied itself, its related entities and its assets to the risk in that one funding arrangement. If a 'worse case scenario' arises, such as default, all the entities and all the assets will be at risk of actions by the lender as it takes steps to realise secured assets in order to repay itself amounts owed under the lending arrangements. This could leave the borrower with permanent scarring in all aspects of its business and the people who are cared for by that business could be similarly marked.

HOW IS RING-FENCING ACCOMPLISHED?

Ring-fencing is effected by the security structure that is used for lending arrangements specifically not including the ring-fenced assets. Generally speaking, a 'broad brush' approach is taken by lenders to secure their lending. In an ideal world, lenders have the benefit of being the first ranking and sole secured party over all the assets (present and future) of the borrower. To give the lender such protection, typically, a widely worded 'all monies' debenture (which provides the lender with security for all monies that lender lends to that borrower, thereby including future amounts lent as well as amounts being considered at the time the debenture is entered into) will be requested because this provides the lender with security (ie rights of recourse) over all the assets owned by the borrower, present and future. (There also may be charges over individual properties and guarantees from third parties, such as parents, or personal guarantees from owners, sometimes such personal guarantees being secured by a charge over the owner's personal home.) Ring-fencing is accomplished by the security structure and documentation being limited to certain assets and/or entities. This structure is followed through into the documentation.

SO ASSETS AND/OR ENTITIES MAY BE RING-FENCED?

Yes, a borrower with more than one asset may ring-fence as many assets as it chooses, provided the lender is happy with the security offered by those assets which are secured in its favour. Similarly, a borrower that is one of several entities — perhaps related by a group structure — may request that other group entities are kept out of the security cover being provided to the lender to support the relevant funding. As noted, a ring-fenced structure needs to be followed through into the drafting in the lending documents. This includes the security documents such as debentures and charges which need to be limited to the assets providing security. In this way, the ring-fenced assets or entities are outside the lender's reach. They may not be sold and action may not be taken in relation to them by the lender in satisfaction of any amounts owed to it by the care sector borrower.

Progressing to a couple of simple structures, ring-fencing assets and businesses will be discussed below.

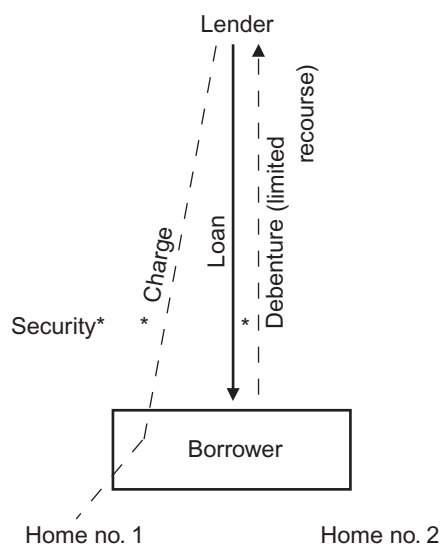
Ring-fencing assets

For example, a borrower with two significant assets, say, two different care homes, may wish to ring-fence Home No. 2 but be happy to use Home No. 1 as security for the loan, as illustrated in Figure 1.

The example shown in Figure 1 assumes the lender was happy to proceed with lending arrangements on this basis (and LTV ratios would be part of the lender’s considerations). The effect of adopting the ring-fenced approach is that Home No. 2 is protected from the lender in the event of the lender terminating the loan and demanding its money back. In such a scenario, recourse by the lender would be limited to Home No. 1. If this borrower had not ring-fenced Home No. 2, the security might look like that illustrated in Figure 2.

As can be seen in Figure 2, because Home No. 2 is not ring-fenced, the lender has full recourse to all the borrower’s assets including Home No. 2. This means that, if the lender terminates lending arrangements and enforces its rights under the lending and security documents, it will be able to sell both homes in order to be repaid. Even if this was not necessary (for example, if the debt was £1m and each home was worth £1m, thus giving a security cover of £2m to the lender for £1m-worth of debt), provided that the lender benefited from security over Home No. 2, the lender would still have the right to take these steps and have the likely effect of jeopardising the borrower’s business — both homes — even if ultimately it did not proceed with forcing a sale of one of the homes. This is because very often just taking preliminary enforcement steps (even if a sale ultimately is not proceeded with) could seriously damage a care business, eg suppliers become aware that finance problems are impacting the business. Therefore, there

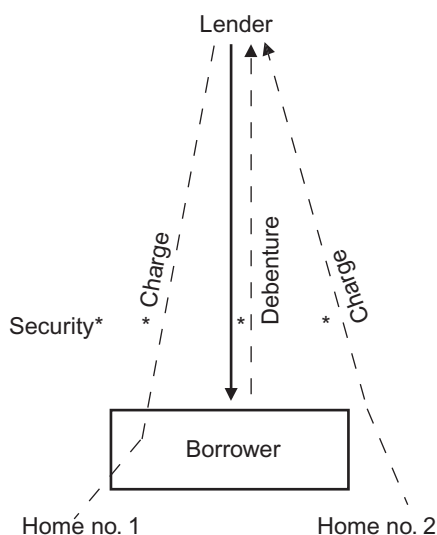
Two assets; one is ring-fenced



*eg charge over Home no. 1 only or debenture limiting recourse to Home no. 1.

Figure 1: An example of ring-fenced assets

Two assets; neither is ring-fenced



eg debenture over all assets of the borrower and including first legal charges over Home no. 1 and Home no. 2.

Figure 2: The example showing non-ring-fenced assets

What this means for the borrower's two homes

would be a knock-on effect from such steps being taken.

Had the lender not had recourse in this way, ie if it had taken security over Home No. 1 only, then Home No. 2 would be unaffected by the financial problems being experienced by Home No. 1. This would mean that Home No. 2 could continue to trade and look after those in its care without difficulty.

Additionally, had Home No. 2 been ring-fenced, it could have been used by this borrower to secure additional funds because it is outside the security relied on for the existing loan. Additional funds could be used to assist repayment of the loan and/or used for another business purpose altogether.

Documentation needs to reflect ring-fencing principles in all terms of the lending arrangements to ensure that the existing lender does not have rights in the documents to prevent or delay a business transaction by the borrower such as an acquisition or disposal involving ring-fenced assets (perhaps as security and/or as a target or purchaser) perhaps by having the power to withhold or delay consent to the transaction.

Ring-fencing entities

A borrower who is part of a group — in Figure 3, one of three subsidiaries owned by the parent and itself owning a subsidiary — may wish to enter into arrangements with the lender whereby the parent and Subsidiary Nos. 2 and 3 are ring-fenced from the loan. (In this example the parent gives an unsecured guarantee to the lender to support the borrowings of Subsidiary No. 1.)

Assuming again that the lender is happy to proceed on this basis, the effect of adopting the ring-fenced approach protects Subsidiary Nos. 2 and 3 from the lender in the event of the lender terminating the loan to Subsidiary No. 1 and demanding its money back.

**Group borrower,
parent and two
subsidiaries are ring-
fenced**

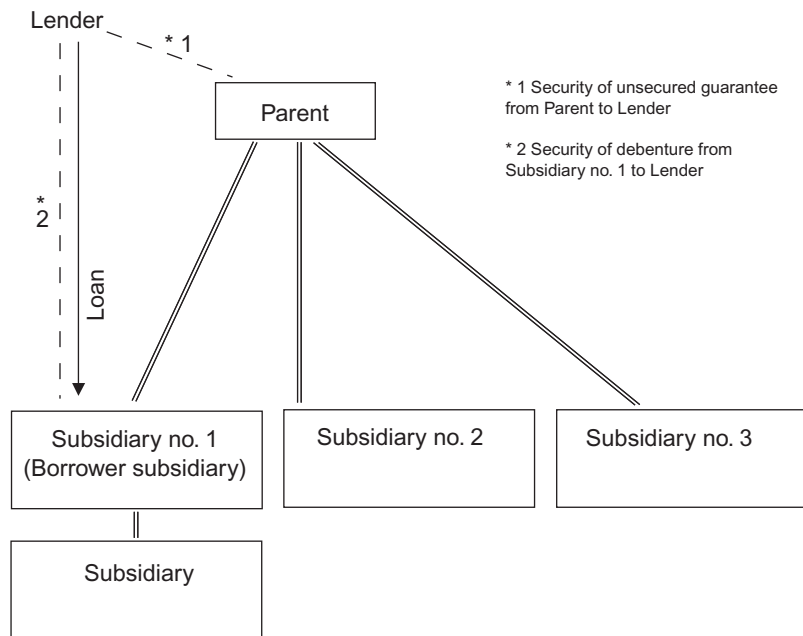


Figure 3: An example of ring-fenced entities

(Although the borrower’s subsidiary would most likely be caught by the debenture unless there were good grounds for excluding the borrower’s subsidiary.)

**The benefits of this
ring-fencing**

The parent would be liable under its guarantee (if it had given one). If the parent had given a secured guarantee (the diagram above shows an unsecured guarantee), the ring-fenced principle would need to be followed through into the detail of the documentation securing the parent’s guarantee by excluding Subsidiary Nos. 2 and 3 from the security given by the parent. The benefits to the group of such a ring-fenced approach would include that Subsidiary Nos. 2 and 3 could be independently financed, being outside the security relied on for the existing loan to Subsidiary No. 1.

Again, documentation would need to reflect this and the ring-fencing principle would need to be followed through into all terms of the lending arrangements, including, as indicated above, in the terms of any supporting documentation such as the parent guarantees (and security given by the parent under the guarantee). It would be important to ensure that the existing lender did not have rights in the documents to prevent or delay a move by the parent or another subsidiary to fulfil a business objective such as acquiring or disposing of an asset or subsidiary or changing its ownership structure in a minor way. Unless the detail in the documentation is attended to, such acts involving ring-fenced entities could be prohibited by the lending documents and attract default consequences if such actions are taken without permission.

If the borrower had not ring-fenced Subsidiary Nos. 2 and 3, the security might look like that illustrated in Figure 4.

Group borrower: full recourse, ie no ring-fencing

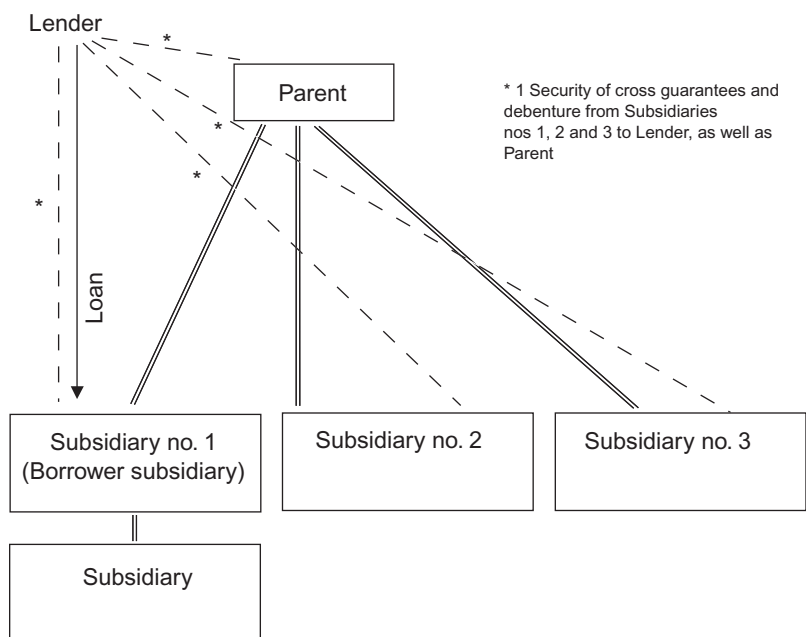


Figure 4: The example showing non-ring-fenced entities

What this means for the group

As can be seen in Figure 4, because Subsidiary Nos. 2 and 3 are not ring-fenced, the lender has full recourse to the entire group, including Subsidiary Nos. 2 and 3. Therefore, if the lender terminates lending arrangements and enforces its rights under the lending and security documents, it will be able to take proceedings against all group entities, not just the borrower, Subsidiary No. 1. This could have a paralysing effect on the business of all the group entities — once again even if not necessary — provided the lender had the rights (by having in place the type of security set out above), it would be able to do this.

The effects, had recourse been limited

Conversely, had the lender not had recourse in this way, ie if it had taken security over Subsidiary No. 1 only, then group entities which remained outside the security structure, ie Subsidiary Nos. 2 and 3, would be relatively unaffected by the financial problems being experienced by Subsidiary No. 1 and could continue to trade and look after those in their care without problem, anxiety etc. Additionally, as in the above example where Home No. 2 had been ring-fenced and could have been used by the borrower to secure additional funds, so could Subsidiary Nos. 2 and 3 be used as a way of offering security for additional borrowing funds.

PARTICULAR ADVANTAGES FOR GROUPS ENTERING INTO RING-FENCED ARRANGEMENTS

In a group scenario, ring-fencing can be a most positive strategy. In addition to the substantial risk management benefits, ie whereby businesses held by different subsidiaries can be protected from adverse effects on the occurrence of a default by another group

Ring-fencing is especially important for care sector borrowers

member, a ring-fenced approach can support a group culture which encourages independent performance by different group subsidiaries or other entities. In the care sector, one might see different homes owned by different subsidiaries; following a ring-fencing strategy can allow the subsidiaries to be independently financed and also to help each other when appropriate. This can be done without undue restriction from the lender.

'Free' assets can be used elsewhere

WHAT DOES RING-FENCING GIVE THE BORROWER AND THOSE WHO ARE IN THE BORROWER'S CARE?

If a borrower has adopted the ring-fencing principle it has the freedom to operate the ring-fenced part of its business as it sees fit, for the benefit of itself and those in its care. It may take actions and fulfil its business objectives at its discretion in line with the needs it determines by applying its expert care sector knowledge. The borrower will be able to use its ring-fenced or 'free' (ie free from security) assets to support its business dealings and, in particular, any additional finance arrangements it, its parent or fellow subsidiaries wish to enter into.

In the face of difficulties, ring-fenced assets are safe

A borrower who experiences extreme difficulties will have the comfort of knowing that assets or entities that have been ring-fenced will be safe from the consequences of the difficulties faced by that borrower. Taken to the extreme, this could mean that, although one home or subsidiary failed, the disruption caused by such failure could be confined. This, in turn, would mean that those people being cared for by homes or entities successfully ring-fenced would not suffer the disruption or worry of, for example, a forced sale or closure. They would remain relatively unscathed by the borrower's difficulties.

Consider the lender's point of view when making an approach

A BORROWER ALREADY HAS ARRANGEMENTS ON AN ALL MONIES AND OPEN SECURITY BASIS — WHAT CAN BE DONE?

Consideration needs to be given as to whether or not a ring-fenced approach is likely to be acceptable to the lender from a security cover point of view. Other key factors will be the general health of the business and its track record in making payments on time as well as the borrower/lender relationship. If it seems that matters are such that a ring-fenced approach would be accepted by the lender then an approach should be made to the lender to ask that this be adopted. If such a change in arrangements is sought because, for example, it is wished to raise funds for a positive business objective such as acquisition, development or expansion, a lender is likely to be interested. After all, this potentially will be new business for the lender and a borrower with a good track record makes a lender's job easier when it goes through its own internal hoops at credit etc.

CONCLUSION

The credit crunch raises real concerns for borrowers. A care sector

borrower has its own concerns, reflecting, among other things, diversity of corporate structures as well as the tendency for medium to long-term lends. Ring-fencing is a protective mechanism that can be used by borrowers wishing to minimise the risk of borrowing as well as preserve as much freedom as possible for future business transactions. The care sector borrower deserves the protection of considered and tailored funding arrangements with ring-fencing where appropriate.

References

1. *Financial Times* (2008) 'Rally runs out of power as credit clouds darken', *Financial Times, Markets*, 12th April.
2. For a detailed explanation of the LTV requirement and its implications, please see Clarke, E. (2008) 'Feeling the squeeze, Part 2: How care sector borrowers can be rescued from a breach of banking arrangements caused by poor property value', *Journal of Care Services Management*, Vol. 2, No. 3, pp. 277–285.
3. See Clarke, E. (2008) 'Feeling the squeeze: How borrowers in the care sector will be affected by the climate in the lending market and what can be done about this', *Journal of Care Services Management*, Vol. 2, No. 2, pp. 134–142.
4. Also relevant: rescue techniques such as bringing in other assets to support an LTV ratio, additional security etc, see Clarke, ref. 2, above.
5. See Clarke, refs. 2 and 3 above.