Whole business securitisation

Maximising your assets

CHRISTIAN LAMBIE of ALLEN & OVERY examines the key issues facing companies wishing to securitise their whole business in order to raise funds.

In the last few years a wide range of assets have been securitised. For example, Formula One has securitised its long term media revenues by issuing eurobonds (PLC, 1999, X(6), 13) and various forms of intellectual property have been securitised in order to access the full value of a company's intellectual property portfolio (see "Intellectual property securitisation: The creation of a new asset class", PLC, 1998, IX(8), 37).

Securitisation transactions, such as the London City Airport securitisation in 1999, established the concept of the "whole business securitisation", that is, a securitisation raising funds secured on the cashflows generated by the business of an operating company (see News Brief "Securitisation: New asset classes," PLC, 1999, X(11), 11). Since then, whole business securitisation has become an increasingly common funding method, for example, to refinance leveraged acquisitions and therefore provide an additional exit strategy for venture capitalists seeking to diversify their funding sources.

This article explains:

- The concept of whole business securitisation and how it differs from a traditional "true sale" securitisation.
- The principal structural features of this type of transaction.
- Factors commonly taken into account when deciding which businesses are suitable for this technique.
- The role of the various advisers and rating agencies.
- Commonly negotiated covenants and security packages required.
- The principal tax issues.

**WHAT IS SECURITISATION?**

Securitisation is a means of raising finance secured on the back of identifiable and
"True sale" structure

In a basic "true sale" securitisation:
- The owner of the assets (the originator) sells the assets which are to be securitised to a special purpose vehicle (SPV) which pays for them by issuing debt securities to investors on a fixed or floating rate basis.
- The securities may be issued on a public stock exchange or privately.
- The principal and interest payments on the debt are funded out of the cashflows generated by the underlying assets.
- The SPV usually creates charges over the securitised assets to secure its obligation to repay the finance raised. This security is granted in favour of a security trustee mainly for the benefit of the investors.

(See box "True sale structure".)

The transfer to the SPV is by "true sale" (a complete transfer of the assets so that they no longer belong to the originator and the securities issued to finance the purchase of the assets are not the originator's liability for the purposes of accounting, bankruptcy, capital adequacy and tax rules). A true sale removes the assets from the originator's balance sheet (because the transfer is with limited or no recourse to the originator). It is also intended to ensure that the transaction cannot be set aside under the Insolvency Act 1986 as a sale at a preference (section 239) or at an undervalue.

Predictable cashflows derived from a particular class of assets (such as rents, receivables, mortgages or operating properties). Almost any assets which generate a predictable income stream can be securitised.

Typical secured loan structure

1 Grants security over shares (for secured loan)
2 Security for secured loan
3 Security for bonds
Advantages of whole business securitisations

There are a number of advantages for the borrower:

- Realising the value of the assets particularly where a business is unable to reflect the value of its intangible assets such as intellectual property on its balance sheet or to raise money against it specifically. For example, London City Airport raised more capital through its whole business securitisation than would have been available from the bond market so that it can repay existing debt and finance acquisitions.

- The borrower retains control of the business and does not have to sell assets. The securitisation can be structured so that the borrower retains any upside in the assets (in other words, all the profit or surplus cash generated by the assets and not required to pay the financing costs or used for credit enhancement) as well as the residual value in the assets at the end of the financing.

- The bonds are investment grade (that is, cheaper) debt with the cost benefits which that brings for a company which, on its own financial strength, would most likely not have investment grade credit ratings.

- The influx of cash brought about through a securitisation can increase liquidity.

- Funding derived from the capital markets can be very competitive, with rates marginally above those at which banks lend to each other in the London interbank market. Therefore it is cost efficient.

- Gaining access to a new or wider investor base by raising funds in a form (that is, rated and/or listed bonds issued on the international capital markets) which makes the debt available to institutions that might not otherwise be able to invest in or lend to the owner of the assets.

- Securitisations can be structured on a tax efficient basis.

Whole business securitisation

This term is used to describe a securitisation where the cashflows derive not from the repayment of debt (such as residential mortgage loans) or other pre-contracted cashflows or receivables (such as trade receivables) but from the entire range of operating revenues generated by a whole business (or a segregated part of a larger business) (see box "Advantages of whole business securitisations").

Whole business securitisation has been used by a wide variety of businesses to raise finance, from Welcome Break and RoadChef (motorway service areas), Westminster Healthcare (residential care homes), Wightlink (ferries), London City Airport (airport revenues), the Really Useful Theatres group (theatres and production), Tussauds Group (waxworks and other entertainment venues). Public house companies (such as Punch Tavens) are also familiar with the whole business securitisation market.

There is no formula that determines whether a business is suitable for securitisation. However, in whole business securitisations to date the businesses in question produced stable, predictable cashflows (backed up by historical data). The following types of businesses are particularly well suited:

- Regulated industries because of the difficulties for other companies trying to set up in competition.

- Established businesses which require high initial capital investment because this acts as a barrier to entry into the market for potential competitors.

- Businesses which to a degree are "recession proof" (such as pubs).

The rating agencies involved will concentrate on certain factors (the ability to continue to generate expected revenues, through recessions and different interest rate environments) (amongst others) to determine whether they believe that expected income can in fact be maintained. The rating agencies are conservative in this analysis and do not assign investment grade ratings lightly.

The principal legal assumption which the rating agencies will make is that the borrower or borrowers (which are of course operating companies and not bankruptcy remote SPVs) will become insolvent and go into liquidation shortly after the issue of the securities. Much of the legal structuring which surrounds the securitisation of an operating business therefore is designed to ensure that the security trustee (via an administrative receiver) has continued and uninterrupted access to the revenues capable of being generated by the borrower(s).

Secured loan structure

In contrast to the "true sale" structure, a whole business securitisation uses a secured loan structure to ensure that the core assets that are required to ensure the continued generation of operating revenues can, if the borrower(s) becomes insolvent, continue to be managed by an administrative receiver with a view to repaying the debt over the scheduled term (see box "Typical secured loan structure"). Because rating agency assumptions (see below) used in calculating the maximum debt proceeds depend primarily on the earnings before interest, tax, depreciation and amortisation (EBITDA) generated by the business in question over a lengthy period of time, a "fire sale" is not envisaged. An administrative receiver has to be able to run the business in question for the full term of the debt.
Why is the bond issuer offshore?

As a general rule, the giving by a company or its subsidiaries of financial assistance to the purchaser for the purpose of the acquisition of shares in the company or its holding company is unlawful. However, by using the whitewash procedure, a company may give financial assistance for the acquisition of shares in that company or a subsidiary may give financial assistance for the acquisition of shares in its holding company, provided the holding company is a private company and there is no intermediate public company (sections 151 to 158, Companies Act 1985; see feature article "Financial assistance: When is it permitted?" PLC, 2000, XII(6), 49).

Whole business securitisation is frequently used in the context of acquisition debt refinancing which has to be whitewashed to avoid falling foul of the financial assistance prohibition.

Public companies cannot use this procedure and private companies cannot issue securities to the public. Therefore, by locating the bond issuer (the issuer) offshore, for example, in the Cayman Islands, which has no legislation prohibiting financial assistance, this problem can be overcome.

However, to ensure that (under current law) the borrowers can pay interest gross (that is, free of any withholding tax) to the issuer, the issuer has to be UK tax resident to enable the group income election to be maintained (see "Principal tax issues" in the main text).

If there is no financial assistance issue, the issuer can be located in the UK.

As "profit" (as an accounting term) is dependent to a large degree on accounting policies, which can vary, EBITDA is used as the principal measure of cashflows being generated by a borrower or borrowers.

Every material operating company which generates EBITDA for which credit is being given by the rating agencies will be a "borrower" in a whole business securitisation. For the purposes of this article, however, references will be to one borrower only. In addition, all subsidiaries of the borrower (if any) will be required to grant guarantees for the obligations of the borrower.

In this structure:

- The bond issuing company (the issuer) (which will be a SPV and a sister company of the borrower) is typically UK tax resident but incorporated elsewhere (see box "Why is the bond issuer offshore?"). The issuer grants a loan (the loan) secured on the assets to be securitised to the borrower or a new subsidiary to whom the assets have been transferred.

- The issuer issues senior debt and subordinated debt to fund the loan. They can be fixed or floating rate depending on investor demand.

- The loan is secured in favour of an independent security trustee, (usually a trustee company) primarily for the benefit of the issuer.

- The issuer then grants security over all its assets (which comprise primarily its rights as senior secured creditor under the loan) in favour of a security trustee for the investors the other creditors of the issuer (such as any swap or liquidity provider) (see "Security packages" below).

- The loan is always issued in a number of tranches to match the classes of the bond issue. However, junior tranches of the loan are not subordinated in the sense of providing credit support to the senior tranches. Instead, tranching of the loan aids interest rate calculations. The interest rates on each tranche will reflect the interest rates payable on the corresponding class of bonds (or, if the relevant class of bonds is a floating rate instrument, the relevant swap rate plus the margin).

- The bonds issued are always rated by a rating agency or agencies (for example, Fitch, Standard & Poor's and Moody's) although sometimes a junior tranche is unrated (see box "Advantages of rating").

Given the fixed assumed cashflow, the loan will typically bear interest at a fixed rate. The rating agencies will determine, in conjunction with the manager of the bond issue, the maximum amount of debt proceeds which the normalised cashflow (that is, an amount of EBITDA which it is assumed that the borrowers will generate, on an annual basis, until the debt is repaid) can bear. As with any other form of financing, if the prevailing market rates rise, the amount which can be borrowed will reduce.

Hedging liabilities. If a class or classes of floating rate bonds are issued, the issuer's fixed rate income (from the corresponding loan tranches) will be swapped into a floating rate cashflow to ensure that the issuer is perfectly hedged (a rating agency requirement). The issuer will then enter into a swap agreement with a counterparty with a credit rating at least as high as the intended rating of the public bonds issued.

Alternatively, the borrower could pay floating rate interest under the relevant secured loan tranches, but it would have to purchase an interest rate cap (from a suitably rated counterparty) at the outset of the transaction to guard against the risk that the aggregate of the floating rate index plus the margin might exceed the fixed rate which the rating agencies determine the cashflows can support, bearing in mind the principal amount of the debt.

Liquidity facility. Most securitisations employ some form of liquidity enhancement (in addition to credit enhancement) in order to bridge any timing gaps between the asset cashflows and payment obligations on the securities issued.

Therefore, the issuer will enter into a liquidity facility with a bank to cover short-term shortfalls due to the borrower to enable it to continue to meet its debt service obligations to bondholders. This facility is frequently sized to cover in excess of one year's debt service. This is because in the event of the insolvency of the securitised business, it usually takes administrative receivers some time after appointment to commence servicing the rated debt.

Having the liquidity facility in a separate bankruptcy remote company will ensure that while time may be needed at the borrower level for an administrative receiver to sort out the affairs of the borrower, the issuer will not fail to make payments when due (see box "Bankruptcy remoteness"). Credit ratings typically address both full and timely payments.

Similarly, it is more common to have any required hedging facilities at the issuer level to avoid payment interruptions if at all possible. This has the advantage of easier negotiations with hedging counterparties, none of which relish the prospect of not being able to terminate a
Advantages of rating

A credit rating of the debt securities issued by the bond issuer is usually necessary to:

- Access the public debt markets.
- Maximise the investor base.
- Alleviate fears that investors may have about new asset classes that they do not fully understand.
- Assist the financing to be more cost effective as the higher the rating, the lower the corresponding cost of funds.

In securitisations a high credit rating is usually achieved as a result of:

- Quality of the assets.
- Arrangements for credit enhancement and liquidity support.
- Legal structure and covenants imposed on the borrower and its group.

- The extent to which any assets of a borrower may be incapable of being subject to security. For a security trustee to be able to appoint an administrative receiver it is essential that it has security over the whole or substantially the whole of a company’s assets. This must be looked at on a company by company basis. Any material lack of security over a company’s assets gives rise to the risk that if the company gets into financial difficulties an administrator may be appointed (preventing the enforcement of security or the taking of other action against the company) (see box “Features of administrative receivership”).

Covenants

The principal commercial documents required in a whole business securitisation are contained in the loan agreement between the issuer and the borrower. The security trustee will be party to that agreement to obtain the benefit of the borrower’s covenants directly.

The covenants are geared towards protection of the income producing assets which exist as at the date of the bond issue. Little or no credit is given by rating agencies for anticipated growth in income or activities. The arranger of the securitisation is an intermediary to the capital markets and the rating agencies. Given that much of the negotiation of financial covenants is driven by financial modelling agreed with the rating agencies, there is often little benefit in pushing for carve-outs (for example, allowing for additional third party indebtedness or a higher threshold for finance...
### Features of administrative receivership

For a creditor (such as a security trustee) to appoint an administrative receiver it must have security over "all or substantially all" of a company's assets. This is a question of fact decided at the time of appointment of the administrative receiver.

A creditor entitled to appoint an administrative receiver is entitled to receive notice of the presentation of a petition for administration and to block the appointment of an administrator.

Events allowing the creditor to enforce security and appoint an administrative receiver should include the presentation of a petition for administration; if a creditor has to wait until an administration order is granted it could be too late to take any action.

If an administrator is appointed, then no creditor (secured or unsecured, including the security trustee) can take any action against a company or its property, without leave of court.

An administrative receiver's main duty is to the creditor that appoints him.

*(See sections 10 and 11 of the Insolvency Act 1986.)*

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**Financial covenants.** The principal financial covenants which are required are:

- An EBITDA/debt service ratio. This ratio (calculated usually on a rolling four quarter basis) is central to the rating agencies' financial analysis. The amount of actual cash available to service debt directly bears on the amount of rated debt which the rating agencies will allow to be raised. Although any draft documents will start with a relatively standard definition of EBITDA, consideration should be given to the possibility of adjusting that definition so as to include other amounts (for example, cash reserves) required by the rating agencies intended to provide credit enhancement to the transaction.

The debt service figure will typically be derived from the loan payments and any other amounts (for example, security and bond trustee fees, paying agency fees or working capital facility payments) which rank senior to the loan. Fully subordinated intra-group indebtedness should be excluded on the grounds that it cannot interfere with the servicing of the rated debt. It is most common to have other third party financial indebtedness prohibited.

- Restrictions on the payment of dividends or similar distributions (tested by reference to the above ratio and full compliance with other covenants).

**Operational covenants.** The nature of operating business securitisation and the fact that the debt is long-term, allows borrowers greater flexibility in the operation of their businesses than would typically be seen with bank debt. If, for example, the restrictions on acquisitions of new businesses prove to be too restrictive, there is no relationship banker (the borrower's principal banking contact within a bank) from whom a borrower might seek a waiver. Although it would always be open to a borrower to seek security trustee consents to changes to covenants in the future, this process is more cumbersome and costly, would often require rating agency approval and, in some cases, bondholder consent.

There will be an overriding obligation on the borrower to run its business prudently, but little detail as to how the business should be run. The scope of business activities will be restricted to the industry sector in which investors think they are investing and which the rating agencies and lead manager are reviewing. Any divergence outside that sector would probably need to be managed through group companies that are not part of the securitisation sub-group. (Although the lead manager will, together with co-managers, underwrite the issue of bonds, they are not party to the transaction documents in a whole business securitisation. Their role is twofold: advising the borrower as to the most efficient commercial structure and acting as intermediary to the markets and the rating agencies.)

Although specific security will be taken over all bank accounts of the security group, unless those accounts are specifically set up for the transaction (for example, to provide credit or liquidity reserves) the covenant package will not seek to specify how the funds in those accounts are to be applied on a day-to-day basis. This would be impractical for an operational business (as opposed to, for example, a commercial property business running on quarterly cashflows).

**Security packages.** Security packages protect creditors (represented by the security trustee) on insolvency giving priority over other creditors in accordance with applicable priority rules and control of management of the borrower to the security trustee (or an administrative receiver appointed by it). An administrative receiver's primary duty is to maximise the return to the relevant secured creditors.
Bankruptcy remoteness

This term is applied by rating agencies to a company which:

- Is newly incorporated.
- Is a special purpose vehicle (SPV) which covenants not to undertake any activities, or incur any financial indebtedness, other than the very limited activities which it is specifically permitted to undertake as part of the securitisation.
- Is not VAT grouped with any other entity.
- Has no employees or premises.

The advantage of bankruptcy remoteness is that the rating agencies will usually assume that a company complying with these criteria will not go into liquidation or become insolvent. This is in contrast with their assumption that an operating company will become insolvent shortly after closing of the securitisation. This is what drives much of the legal analysis of a securitisation, although it should be noted that bankruptcy remoteness is a question of fact, not of law. It is impossible to be sure that a company will not go into liquidation.

Given the nature of these criteria, it would be virtually impossible for an operating company to be viewed as bankruptcy remote.

Given the limited nature of the issuer's activities, and the fact that it is a bankruptcy remote SPV with a carefully defined set of assets, this is rarely a controversial matter.

PRINCIPAL TAX ISSUES

For the issuer to operate as a pass-through vehicle (and therefore not interrupt cashflows):
- The borrower has to be able to make gross payments of interest (that is, free of withholding tax) on the loan.
- It has to be tax neutral (by having sufficient taxable deductions to offset taxable income).

Withholding tax

The borrower cannot rely on this exemption or the exemption which allows UK corporates to make gross payments of interest to a qualifying bank (section 349(3)(a), ICTA).

Group income elections. Ensuring that there is a group income election in place between the borrower and the issuer can solve this problem if the issuer is UK tax resident (despite being incorporated offshore) and brings the interest within the charge to UK corporation tax. For this reason the transaction will need to be structured so that the bond issuer is UK resident for tax purposes. However, the group income election would not survive the liquidation of the common link in the group (that is, the company which links the payer and the payee, by virtue of which the group income election is granted) (see section 212, ICTA).

Therefore in a securitisation, where the rating agencies require all parties to assume the insolvency of all group companies, this group income election is protected by the insertion of a bankruptcy remote SPV (shown as "new intermediate holding company" in box "Typical secured loan structure"). Each of the borrowers and the issuer should then be a direct subsidiary of this SPV. An assumption of the continued solvency and non-liquidation of the SPV is persuasive in convincing the rating agencies that the group income election will survive even if all other group companies go into liquidation.

Although failure of the group income election would trigger an obligation on
Glossary

**Administrative receiver.** A receiver or manager of the whole or substantially the whole of a company's property, appointed on behalf of the holder of a debenture of the company which was created as a floating charge, and authorised to run the company's business and dispose of the assets either piecemeal or as part and parcel of the sale of the business as a going concern: the principal duty being to realise the indebtedness owed to the secured creditor by which it was appointed. Administrative receivership is almost always followed by the liquidation of the company.

**Chapter 11.** Chapter 11 of the US Bankruptcy Code is the US equivalent of administration in the UK under which companies are protected from their creditors for a given period while a rescue is attempted.

**Group income election.** A holding company and its subsidiaries can jointly elect that interest and certain other payments be paid without deducting tax at source. All the companies must be UK resident and the holding company must beneficially own, directly or indirectly, more than 50% of the subsidiary, both economically and in terms of share capital.

**Interest rate cap.** A variant on an interest rate swap. An example would be a contract under which a market participant would agree, in exchange for a one-off premium, to make payments to a user if market interest rates should exceed a predetermined level (the "cap"). The payment would be equal to the notional amount (for example, the same amount as the amount of a borrowing) multiplied by a rate equal to the excess of the current market rate over the cap. This contract enables a user which has borrowed at a floating rate of interest to cap its exposure to rising interest rates, while retaining the opportunity of lower borrowing costs if interest rates fall.

**Orphan vehicle.** A company which is not required to be consolidated as a subsidiary or subsidiary undertaking of the originator under the Companies Act 1985. The aim is usually that the SPV's shares, assets or liabilities should not be consolidated on the originator's balance sheet.

**Quoted eurobond exemption.** This exemption from withholding tax which currently only applies to bonds which are in bearer form and listed on a recognised stock exchange will be extended to cover registered bonds from April 2001.

**Receivables.** This is not legally defined, but is used to mean the amounts owed to a business by debtors.

**Senior debt.** Bank loans that are intended to rank equally with (or, in the case of secured senior bank debt, ahead of) other unsecured and unsubordinated debt on a liquidation of the borrower.

**Subordinated debt.** Debt which ranks for interest and repayment after other borrowings of a company.

**Swap.** A swap is a derivative contract between two parties to exchange a series of interest rate flows or payments in a given currency for a stated period of time. Swaps enable parties to convert:

- Fixed rate liabilities or assets into floating rate liabilities and vice versa.
- Liabilities in one currency into another currency.

**Thinly capitalised.** Where a company's borrowings (debt) are high in relation to its share capital (equity) it is thinly capitalised.

**Whitewash procedure.** A private company can give financial assistance for the acquisition of its own shares if the so-called whitewash procedure under the Companies Act 1985 is followed. Broadly, all directors of the company must swear a statutory declaration that in their opinion the company will remain solvent for at least 12 months and the shareholders must pass a special resolution approving the financial assistance. Creditors have a right to object.

**Withholding tax.** Tax imposed on gross income and enforced by a deduction obligation imposed on the person paying income at the time of payment. Frequently applies to dividends, interest and royalties.

The government recently announced proposed changes in the Pre-Budget Report (in November 2000) to the withholding tax regime, the effect of which should be to allow UK corporation taxpayers to make payments to other UK corporation taxpayers free of withholding tax. The details of the proposals are not yet known but it is likely that, if enacted, the changes would significantly alter some structural aspects currently seen in whole business securitisations. In particular, the steps needed to preserve group income elections (as described above) may be removed altogether.

**Issuer's tax neutrality**

Under the loan relationship rules in the Finance Act 1996, the issuer should be able to obtain matching deductions on the payments of principal and interest on the bonds to offset against its taxable income. The fees (for example, paying agency and trustee fees) should also be a deductible expense for the issuer if it is deemed to be an "investment company" (see feature article "Corporate debt: The new tax regime", PLC, 1996, VII(3), 29).

The Inland Revenue will not allow the bond issuer to be classified as an "investment company" where the company is incapable of making at least a minimum level of taxable profit. This concern is addressed by ensuring that the weighted average interest rate on the loan exceeds the weighted average interest rate on the bonds to ensure the possibility of a minimum amount of taxable profit in the issuer. This additional cost of borrowing in the short to medium term can be paid out by the issuer as a dividend in the future.

**VAT grouping**

It is usually advantageous for companies within a larger group to be grouped for VAT purposes. If companies are registered as a VAT group, supplies between the borrowers to gross up payments to the issuer, the borrower's income is assumed by the rating agencies to be insufficient for this purpose. The issuer should ultimately receive credit from the Inland Revenue for amounts withheld by the borrowers, but this is a cost to the issuer, which the rating agencies would otherwise take into account when sizing the amount of debt which may be raised. These costs are both cashflow/timing costs and absolute costs (if the bond issuer requires to use its liquidity facility to cover shortfalls, interest will be chargeable).

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group companies will be disregarded (see "Value Added Tax: A guide for the non-tax specialist", PLC, 1998, IX(10), 21). Any business carried on with third parties by group members will be treated as if it were carried on by the representative member of the group (section 43, Value Added Tax Act 1994). All members of the group are, however, jointly and severally liable for any VAT due from that representative member.

From a securitisation perspective it is important to ensure that the borrower is not VAT grouped with any company other than additional borrowers. Any divergence from this rule can have negative consequences from a rating perspective because the amount and several liability which VAT group rating brings will cause the rating agencies to assume that the borrower will be liable for VAT even if unconnected to its business.

Secondary tax liabilities

Secondary tax liabilities are a general rule, companies in the same corporate group are not liable for the corporate tax liabilities of their affiliates (see "Taxing groups of companies: Moving the goalposts?", PLC, 2000, XII(7), 27). The principal secondary tax liabilities which cause concern to investors and rating agencies relate to the possibility that a security group company may have a latent tax liability for a chargeable capital gain. This can arise if a security group company has had transferred to it, within the previous six years, an asset in respect of which there was a rolled-over gain. In addition, one group company can be liable for the tax bill of an affiliate in certain circumstances where companies are being manipulated with a view to reducing tax liabilities (sections 767A and 767A.1, ICTA). The risks of any borrower becoming secondarily liable in this way must be explored during the due diligence exercise. A fully negotiated warranty and covenant package and detailed tax opinion on the group's affairs will be required to satisfy investor and rating agency concerns.

What next?

More and more businesses are using whole business securitisation as a method of financing. Investors who would normally be wary of structured bonds are beginning to view securitisation bonds as another form of secured corporate debt.

A greater challenge for the future is applying the techniques to operating businesses in the larger economies of mainland Europe. This has already started (for example, a Swiss railcar leasing company has securitised its operating revenues) and it is clear that corporates with operations in many European jurisdictions are interested in reaping the benefits that securitisation brings.

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