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ANNEX 5.2 PROTECTING PUBLIC INVESTMENTS

This annex discusses how public sector organisations which provide grants to the private sector and others should protect their investments where grants are used to buy or improve assets.

Clawback

A.5.2.1 Public sector organisations providing funds to others to acquire or develop assets should take steps to make sure that public sector funds are used for the intended purposes for which the grant is made. It is usual to consider setting conditions on such grants, taking into account the value of the grant, the use of the asset to be funded and its future value.

A.5.2.2 The standard grant condition is clawback. This is achieved by setting a condition on the grant that gives the funding body a charge over the asset so that, if the recipient proposes to sell or change the use of the asset acquired with the grant, it must:

- consult the funder;
- return the grant to the funder; or
- yield the proceeds of sale (or a specified proportion) to the funder.

A.5.2.3 However, a charge over the asset is not always essential. Some ground rules are suggested in box A.5.2A.

Box A.5.2A when to consider clawback

clawback desirable

- tangible or intangible assets, including intellectual property rights, crown copyright, patents, designs and database rights, financed directly, whether wholly or partly by grants or grants in aid;
- tangible or intangible assets developed by the funded body itself, financed indirectly by a grant for a related purpose or by grant in aid

clawback not always necessary

- procurement of goods and services, where any liability is adequately discharged once the goods and services have been provided
- where a grant has been provided for research and not specifically for the creation of physical asset, the successful conclusion of the research might be adequate return

A.5.2.4 Because funders, recipients and circumstances can vary so much, there is no single model for clawback. Bespoke terms are often desirable. They should allow as much flexibility as seems sensible. The aim should be to help recipients develop and provide services over the longer term while securing value for public funds. Drawing on the ideas in box 7.2, funders should always settle the terms of each grant with its recipient at the start of the relationship, consistent with its objectives.

Designing clawback conditions

A.5.2.5 The design of clawback conditions for a grant should take account of its circumstances, the underlying policy objective(s) and the funder's approach to risk. A checklist of some common factors to consider is in box A.5.2B. Using this tailored approach can mean different organisations take very different approaches to the same risks.

box A.5.2B: factors to consider in designing clawback terms

- the nature and purpose of the grant
- how the asset will help secure the policy objectives behind the grant
- the expected life of the asset
- the extent to which the recipient is financed out of public funds
- how the asset will be used by the recipient, eg scope for appreciation or generating profit
- how long the funder should retain an interest in the asset
- whether the asset may be sold, with any restrictions on disposal, eg as to price or purchaser
- whether there is sense in reassessing after a certain period or on a given trigger
- whether the terms of clawback should vary according to a factor such as the asset value (in which case the terms may need to provide for periodic valuations)
- when the policy objectives should be delivered
- the funder's legal powers and the recipient's legal position (eg as a company or charity)
- any other relevant legal factors, eg EU rules on state aids

A.5.2.6 In setting terms and conditions for grants, funders should consider what could happen if things do not proceed as intended, notably what should happen if:

- the recipient does not behave as expected; or
- external conditions are very different to plans; or
- the recipient goes into liquidation (eg should the funder take priority over unsecured creditors).

Duration of charge

A.5.2.7 It can make sense to relate the funder's right to clawback to the policy objectives of making the grant rather than allowing it to persist indefinitely unchanged. Some policy options are outlined in box A.5.2C. If the clawback is linked to the value of an asset which is likely to appreciate, there is a risk that the recipient may face a disincentive to participate, so care and sensitivity may be needed.

A.5.2.8 However, it can also make sense to moderate grants conditions by using terms such as:

- a break clause allowing the funder and recipient to consider whether the objectives of the funding have been achieved, triggering the end or reduction of the funder's interest in the asset;
- a review clause allowing scope to retain the charge and review the clawback period if the project has not met the agreed objectives;
- releasing the funder's interest in the asset (and so permitting its disposal or use as collateral) at the end of the agreed charge or clawback period.

box A.5.2C options for clawback duration or assets as collateral

- keying it to the objectives of the grant
- relating it to the period over which the intended benefits are to be delivered
- settling clawback rights on a declining scale, eg falling to zero by the end of an agreed period, or the asset's useful life, or by when the policy objectives are deemed delivered
- allowing the recipient to use as collateral the difference between the market value of the asset and the original grant

A.5.2.9 It is common to prohibit recipients from using the assets they acquire or improve using grants as collateral in borrowing transactions. This is because the public sector funder might be forced to take up the recipient's legal liability to service debt should it fail. However, if a funder agrees that a recipient may use assets acquired or developed with grants as collateral, it should consider carefully what conditions it should apply. Some freedom of this kind may help the recipient make the transition to viability or independence. For example, a funder might allow a recipient to retain income generated by using spare capacity in the funded asset.

A.5.2.10 But normally it is important for the funder to retain some control over any use of the funded asset outside the grant conditions. Typically the funder will require the recipient to obtain the funder's consent before raising funds on any part of a funded asset so long as the clawback period continues. Any further conditions should be proportionate, striking a proper balance between encouraging the recipient to be self-supporting and allowing the recipient to use public funds for its own purposes.

Enforcing a claim on a funded asset

A.5.2.11 Where appropriate, funders should secure a formal legal charge on funded assets. This may be particularly important for high risk projects or to prevent the funder becoming exposed to assuming the recipient's debts. It is usual to take a registered charge on land under the Land Registration Act 2002 and its Rules. If the recipient is a Companies Act company, it may make sense to secure a registered charge on the company's book debts.

A.5.2.12 The form and intended duration of any charge should be recorded in the founding documents charting the relationship between the funder and recipient. Both parties will need legal advice, eg covering the statutory background, any relevant EU rules (eg on state aids) and on how the charge would be enforceable. Both parties should also keep track of their outstanding charges. It is good practice to register a land charge, so that it will automatically be taken into account during any sale process.

A.5.2.13 Sometimes a funder may decide not to enforce clawback when a funded asset is sold, even though the agreed clawback period is still in force. Funders should take any such decision consciously on its merits, not letting it go by default. Reasons why a funder might take this approach include:

- the objectives of the grant may have been achieved;
- the recipient may propose to use the funded asset in an acceptable way different from the original purpose;
- the recipient may intend to finance an alternative asset or project within the objectives of the grant scheme out of the proceeds of the sale;
- the funder might agree to abate future grants to the recipient instead of taking the proceeds of sale.

A.5.2.14 If a department decides to waive a clawback condition, it should consider whether it needs to report that waiver as a gift. If so, it should follow the gift reporting requirements in annex 4.12.

A.5.2.15 If it is proposed to sell a grant recipient with a live charge, the funder should take legal advice on whether it can enforce the charge on the proceeds of the sale. The funder should consider the legal position of the proposed purchaser of the grant recipient, and in particular whether its objectives (eg charitable or as a social enterprise) are in line with the original grant conditions. If the funder becomes aware that such a sale is possible at the time the grant is awarded, it would usually be appropriate to require the recipient to obtain its consent before proceeding. And any request for endorsement of a sale should be evaluated objectively.