Brexit

Key issues for lending and loan documentation

1 January 2021

Introduction

This note considers how Brexit, and in particular the end of the transition period, affects lending and loan documentation.

The UK left the EU on 31 January 2020. However, under the agreement on the UK's withdrawal from the EU, the UK continued in most respects to be treated as if it were still part of the EU until 31 December 2020. Now that this transition period has ended, the full effects of this profound change in UK law and regulation apply.

On 24 December 2020, the UK and the EU finally agreed a deal –the Trade and Cooperation Agreement (the **TCA**) - to govern significant aspects of the trade relationship between the UK and EU from 1 January 2021 onwards. For more information about the TCA, see The UK-EU Trade and Cooperation Agreement: an overview. While the announcement of the TCA has been a source of relief for both UK and EU businesses, its impact on cross-border financial services (including lending) is very limited. See Post-Brexit EU-UK Trade and Cooperation Agreement – Key considerations for financial services.

So to what extent will Brexit change lending and loan documentation in 2021?

Lending authorisation

Consumer credit and residential mortgage transactions apart, lending is not a regulated activity in the UK. EU-based entities will therefore be able to continue to lend to UK businesses without UK authorisation. By contrast, authorisation is required in most EU jurisdictions to lend to local businesses, although in some cases carve-outs apply if lending is not recurring, or is on the basis of reverse solicitation. Local authorisations are also not required if the lender is an EU credit institution regulated under CRD IV, in which case it will have an "EU passport" to lend throughout the EU. Until 1 January 2021, UK banks were able to rely on this passport and so did not need to obtain local authorisations. The position now is much less clear.

There has been much discussion as to whether it will be possible for financial services to be provided between the UK and the EU on the basis of "equivalence" after the end of the transition period. During the negotiations on the TCA, the EU held back from making equivalence decisions (subject to some very limited exceptions) in respect of the UK, while the UK announced wide-ranging equivalence decisions in respect of the EU. If the EU ultimately does make equivalence decisions in respect of the UK, this may provide an alternative means of providing certain types of financial services to the EU from the UK (see The Equivalence Decisions Framework of the EU and UK – Brexit and beyond). However, there is currently no EU equivalence regime relating to lending, and so equivalence decisions will have limited direct relevance to commercial lending.

The TCA itself contains very little of substance on financial services. The UK and EU have jointly declared their intention to agree a memorandum of understanding on financial services by March 2021, although there

is no expectation that this will create any mechanism replacing the EU passport as a means of access to the EU market for UK lenders.

It is therefore unsurprising that many UK banks have already taken steps to set up or expand subsidiary operations within the EU and to transfer to EU-incorporated affiliates certain existing transactions with EU customers.

Loan documentation

Set out below are some of the key drafting considerations for parties to loan agreements in light of Brexit. For simplicity, we refer to English law and the English courts below, but in most respects the position will be the same for other UK laws and courts.

Bail-in clauses

Article 55 of the EU Bank Resolution and Recovery Directive (2014/59 EU) (BRRD) sets out a general obligation on EEA financial institutions to include a bail-in clause in most contracts they enter into that are "governed by the law of a third country". Under a bail-in clause, the other parties recognise that the institution's obligations under the contract are subject to an EEA regulator's exercise of its write-down and conversion powers under BRRD. The UK is now a "third country", bringing English law contracts of EEA financial institutions within scope.

Are any carve-outs available?

- Under Article 55, an EEA financial institution does not need to include a bail-in clause in an agreement governed by a third country law if that institution's local regulator has determined that the exercise of its BRRD powers would be recognised under that third country law. However, the amendments that the UK made to its bank resolution and recovery regime at the end of the transition period mean that bail-in powers exercised by an EEA regulator are now treated in the UK as powers exercised by a "third country" regulator (i.e. there will no longer be automatic recognition in the UK). So it would be reasonable for an EEA financial institution to conclude that this carve-out will not apply to its English law agreements.

- BRRD has now been amended by BRRD II Directive (2019/879 EU) (BRRD II). EU member states (and the UK) were expected to implement most of its measures, including those relating to bail-in clauses, by 28 December 2020. BRRD II amended Article 55 by providing that an EEA financial institution need not include a bail-in clause in a contract if it determines that it is "impracticable" to do so, subject to an obligation to notify its local regulator of this determination. Recital 26 of BRRD II set out some examples of where this impracticability carve-out may arise. Most were obvious but of narrower application, such as illegality. Of potentially wider relevance, Recital 26 also referred to contracts where the EEA financial institution's liability "is contingent on a breach" of the contract. This suggested that an EEA financial institution may be able to avoid including bail-in clauses in its contracts governed by English (and other third country) law, provided it is not due to incur any debt obligations under them. However, on 23 December 2020, The European Banking Authority published its final draft regulatory technical standards on the scope of the impracticability carve-out, which stated that it could not be used simply because the EEA financial institution's only liabilities are contingent on a breach.

Each EEA financial institution will need to consider the precise terms of its own national legislation implementing BRRD and BRRD II, and the approach of its supervising authority. But it seems likely that bail-in clauses will now be included in a wide range of English law finance contracts to which EEA financial institutions are party, or may become a party in the future (indeed, in anticipation of Brexit, this had already become common practice before 2021). The LMA has now included a bail-in clause in its recommended forms of English law confidentiality undertaking and secondary debt trading terms and conditions, as well as its recommended forms of English law facility agreement.

The end of the transition period will have a much more limited impact on UK financial institutions' bail-in clause obligations. The PRA has confirmed that it will use the temporary transitional power granted to it under the European Union (Withdrawal) Act 2018 to defer the obligation to include bail-in clauses in new or materially amended EEA law-governed "phase two liabilities" for the first 15 months after the end of the transition period. Broadly this means that, until 1 April 2022, the obligation only applies to EEA law contracts under which a UK financial institution will incur an unsecured debt obligation (such as when issuing a bond).

In addition, even before BRRD II, the UK bail-in clause rules included a potential carve-out for most contracts where compliance with the obligation is impracticable. Unlike the impracticability carve-out introduced by BRRD II (on which see above) it is clear under the UK rules that the impracticability carve-out can apply where "the liability which would be subject to the contractual recognition requirement is contingent on a breach of the contract" (see PRA Supervisory Statement 7/16). Responding in October 2020 to the EBA's consultation on impracticability, the LMA commented, "*As a result[of PRA Supervisory Statement 7/16], UK firms will not be required to include Article 55 wording in their syndicated loan documents, to the extent that these are governed by non-UK law*." However, UK financial institutions will need to continue to make their own policy decisions on whether to apply the impracticability carve-out to specific contract types, and bear in mind that they need to justify these decisions to the PRA on request.

Jurisdiction clauses

To date, English law loan agreements with EU borrowers have typically included an "asymmetric" jurisdiction clause under which the borrower agrees that the English courts have exclusive jurisdiction to resolve disputes, but the lender or lenders are free to sue the borrower in any other courts with jurisdiction. Before the end of the transition period:

- subject to limited exceptions, both English and EU courts gave effect to this jurisdiction agreement; and
- EU courts enforced any English court judgment arising from a resulting dispute,

in each case applying the recast Brussels Regulation. The recast Brussels Regulation no longer binds English courts or requires EU27 courts to recognise English judgments. The English courts have also fallen outside the scope of the mutual recognition arrangements between courts in the EU and those in Iceland, Norway and Switzerland, pursuant to the Lugano Convention.

On 8 April 2020, the UK deposited an application to accede as an independent party to the Lugano Convention. Although the Lugano Convention does not confer all the benefits of the recast Brussels Regulation, if the UK were to re-join it, it seems likely that lenders to English law facility agreements with borrowers in the EU/Lugano Convention states would generally be comfortable using the same jurisdiction clauses as they have done in the past. The UK's accession to the Lugano Convention requires the consent of the existing members. Iceland, Norway and Switzerland have all provided statements of support. It was anticipated that if the UK and EU were able to conclude an agreement on their future relationship (which they have now done, in the form of the TCA) the EU might then support the UK's accession to the Lugano Convention. However, it has made no mention of the UK's accession to the Lugano Convention since the TCA was announced.

In the meantime:

- On 1 January 2021, the UK acceded to the 2005 Hague Convention on Choice of Court Agreements (the Hague Convention) in its own right. (The EU has already done so.) The reciprocal recognition of jurisdiction agreements and enforcement of judgments provided by the Hague Convention is narrower in scope than that provided by the recast Brussels Regulation or the Lugano Convention. In particular, it (probably) only applies to mutual exclusive jurisdiction clauses and judgments arising from them. As such, for the time being we anticipate that lenders will wish to include mutual exclusive English court jurisdiction clauses in their new English law facility agreements with EU borrowers, rather than asymmetric jurisdiction clauses. This will ensure any resulting dispute, and English court judgment arising from it, will be within the scope of the Hague Convention. When amending pre-2021 facility agreements with an EU borrower, they should also consider revisiting the jurisdiction clause at the same time. Subject to this change to the terms of the jurisdiction clause, lenders entering English law facility agreements with EU borrowers are likely to prefer to continue to choose the English courts to resolve disputes, rather than (for example) arbitration. While an arbitration award made in the UK will be automatically recognised and enforced in EU member states pursuant to the New York Convention, arbitration also has inherent disadvantages for resolving financial disputes, such as the inability to obtain an equivalent to summary judgment.

- In November 2020, the UK and Norway reaffirmed and updated their existing bilateral reciprocal agreement on recognition and enforcement of judgments, to ensure that these would continue to apply

while the UK remains outside the Lugano Convention. Lenders to Norwegian borrowers do not need to use any particular form of jurisdiction clause to come within the scope of this arrangement.

References to EU legislation

Pre-Brexit, it was common for loan agreements with UK and EU parties to refer to specific EU legislation which might apply to some or all of those parties. For example, an increased costs clause might expressly include increased costs arising under CRD IV. Or a sanctions representation or undertaking might only apply to the extent it does not cause a party to breach the updated EU Blocking Statute. EU law is no longer part of UK law. However, pursuant to the European Union (Withdrawal) Act 2018:

- EU law as at 31 December 2020 has been incorporated into UK law as "retained EU law"; and
- in many cases, that retained EU law has been amended by secondary legislation to ensure it works as UK domestic legislation.

For more information, see Retained EU law: the incorporation of EU law into UK law at the end of the transition period.

A reference to EU legislation in a contract cannot necessarily be relied on as a reference to the retained EU law equivalent. Parties should therefore carefully check the definitions and interpretation provisions in their agreements, and consider whether they want to refer to EU legislation, UK legislation, or both. In most facility agreements, parties are likely to prefer broad, inclusive references to legislation. Even if all the initial parties are incorporated either in the UK or the EU, this may change in the future through the operation of obligor accession or loan transfer mechanics.

Choice of governing law

The end of the transition period has had very limited impact on the effectiveness of parties' choice of governing law. EU courts will continue to apply the Rome 1 and Rome 2 Regulations to give effect to a choice of English (or other) governing law (subject to very limited exceptions, which applied before). The English courts are no longer bound by Rome 1 or Rome 2. However, both have become part of the UK's domestic law as retained EU law, subject to some limited amendments under The Law Applicable to Contractual Obligations and Non-Contractual Obligations (Amendment etc.) (EU Exit) Regulations 2019. The end of the transition period has also had very limited impact on English contract law itself, little of which is derived from EU law.

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