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Brexit

Key issues for lending and loan documentation

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Introduction

This note considers how Brexit and the end of the transition period (referred to below as the "implementation period") affects, or may affect, lending and English law loan documentation.

Political and legal background

Exit day, the implementation period and a possible deal on future relations

The UK left the EU on 31 January 2020 (**exit day**). However, this profound change has so far had limited impact on UK law and regulation. Under the agreement on the UK's withdrawal from the EU (the **Withdrawal Agreement**), the UK currently continues in most respects to be treated as if it were still part of the EU from exit day until 31 December 2020 (the **implementation period**). The Withdrawal Agreement provided a mechanism to extend the implementation period but it has not been used. It therefore appears that the full legal consequences of Brexit will begin to be felt from 1 January 2021.

The Withdrawal Agreement does not regulate future trade between the UK and EU, or any other area of potential future EU-UK cooperation, except to a limited extent in relation to Northern Ireland. It remains unclear if a deal on future UK-EU relations will be agreed by 31 December 2020. In some areas, there is an obvious legal fall-back framework in the absence of a deal (for example, if agreement is not reached on tariff-free trade, "WTO rules" will apply); in other areas there is not. Whatever happens, those trading between the UK and EU will face significant regulatory changes (for example, in relation to customs). It also seems likely that, if the UK and EU reach a deal in the coming weeks, it may be a fairly "thin" agreement, meaning that negotiations on some aspects of the UK-EU post-Brexit relations may continue well beyond 2020.

For more detailed background, click **here**.

Lending authorisation

Consumer credit and residential mortgage transactions apart, lending is not a regulated activity in the UK. But lending within or into some EU jurisdictions can only be done by locally authorised entities. This is unless 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. To date, UK-based banks have been able to rely on this passport and so have not needed to obtain local authorisations. To date this has not changed during the implementation period, but the position after that is much less clear.

The Political Declaration agreed by the UK government and the EU alongside the Withdrawal Agreement (the **Political Declaration**) loosely sketched out the nature of the future relationship agreement that they hope to conclude by the end of the implementation period. The Political Declaration suggests that access to each other's financial services markets will be provided on the basis of "equivalence" after the implementation period. EU legislation regulating some types of financial service already include equivalence mechanisms. Broadly, these provide that if:

- an entity has a suitable authorisation from a third country's (i.e. non-EU country's) regulator; and
- the EU has determined that the third country's regulations are equivalent to the EU's,

that entity will be authorised to carry out the relevant financial service in the EU. However, they also enable the EU to withdraw equivalence determinations unilaterally at short notice, and do not apply to all types of financial service. There is currently no EU equivalence regime relating to lending, for example. So, any new equivalence regime in a future relationship agreement would need to be broader and more robust to convince lenders to rely on it in a similar way to passporting. 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 English law loan agreements in light of Brexit,
in particular in anticipation that either:

- a comprehensive future relationship agreement will not be agreed by the end of the implementation period; or
- even if it is, that it will not replicate the substantive pre-Brexit position between the UK and the EU.

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 (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. Until the end of the implementation period, the UK will continue to be treated as part of the EEA. After that, it will be a "third country".

However, even after the end of the implementation period, an EEA financial institution will not need to include a bail-in clause in its English law agreements if that institution's local regulator has determined that the exercise of its BRRD powers would be recognised under English law. In December 2018, in preparation for a "no-deal" Brexit, The Bank Recovery and Resolution and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018 were finalised. These are now due to come into force at the end of the implementation period and provide that, from that time, BRRD powers exercised by an EEA regulator will be treated in the UK in the same way as powers exercised by a non-EU/EAA regulator have been to date (i.e. they will no longer be automatically recognised by the UK regulators). So, it is likely that EEA financial institutions will need to include bail-in clauses in loan agreements they enter following the implementation period, unless a future relationship agreement provides for an alternative before the end of 2020. EEA financial institutions should also consider their local regulator's likely approach to their existing English law agreements. For some time now, it has been common for EEA financial institutions to seek the inclusion of bail-in clauses in their English law loan agreements.

References to EU legislation

It is common for loan agreements with UK parties to refer to specific EU legislation which applies to 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. As described above, at the end of the implementation period EU law will cease to be part of UK law, but the UK will "on-shore" most EU legislation into UK domestic law, with necessary amendments. Will those contractual references to EU legislation automatically include the equivalent UK on-shored legislation?

The 2018 Act does not adequately address this point, either in its own operative provisions or by the changes it makes to the Interpretation Act 1978. Parties should therefore carefully check the definitions and interpretation provisions in their agreements. In some cases, a definition referring to a piece of EU legislation may include a helpful sweeper that would cover equivalent on-shored UK legislation. For example, it is common for a definition of VAT to refer to tax imposed in accordance with the EU VAT Directive, but also to include "any other tax of a similar nature imposed elsewhere". Without such a sweeper, parties should consider broadening the definition itself, or expanding the general interpretation provisions in the contract.

Illegality clauses

Loan agreements typically provide that a borrower must prepay the loan if it becomes illegal for the lender to continue with the transaction. These clauses are coming under greater scrutiny on transactions with UK-based banks and EU27 borrowers, in light of the potential loss of passporting rights referred to above. We have seen isolated examples of lenders attempting to widen the scope of this mandatory prepayment obligation, arguing that some EU27 regulatory regimes are so uncertain that the illegality clause should apply if a lender "reasonably believes" it is illegal for it to continue with the transaction. Not surprisingly, borrowers strongly resist this. On new transactions, it is increasingly common for UK banks to lend to EU27 borrowers through EU-incorporated (and authorised) affiliates, which makes this issue less of a concern.

Choice of governing law

The end of the implementation period will have very limited impact on the effectiveness of parties' choice of governing law. Even in the absence of any future relationship agreement, EU27 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 apply under the current rules). The English courts will no longer be bound by Rome 1 or Rome 2. But The Law Applicable to Contractual Obligations and Non-Contractual Obligations (Amendment etc.) (EU Exit) Regulations 2019 will come into force in the UK. These will incorporate the terms of Rome 1 and Rome 2 into UK domestic law. The end of the implementation period will also have very limited impact on English contract law itself, little of which is derived from EU law.

Jurisdiction clauses

To date, English law loan agreements with EU27 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. Subject to limited exceptions, both English and EU27 courts will currently give effect to this jurisdiction agreement, and EU27 courts will enforce any English court judgment arising from a resulting dispute, in each case applying the recast Brussels Regulation. From the end of the implementation period, the recast Brussels Regulation will no longer bind English courts or require EU27 courts to recognise English judgments.

However, to date we have seen limited change in the approach to dispute resolution clauses in English law loan agreements on account of Brexit. In particular, we have seen only isolated examples of lenders to EU27 borrowers choosing to resolve disputes by arbitration instead of in the English courts. 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. Other reasons that lenders have generally preferred to continue with English court jurisdiction clauses include:

- the UK and EU may agree a regime of judicial co-operation similar to the Brussels Regulation in a future relationship agreement (for example, by allowing the UK to accede to the Lugano Convention in its own right);
- the absence of any such agreement would not mean that EU27 courts will inevitably refuse to enforce English court judgments after the end of the implementation period. The English courts generally give effect to money judgments of foreign courts, even where no formal reciprocal enforcement regime applies (for example, as is the case with US court judgments). One would expect most EU courts to take a similar approach, although local law advice should be obtained;
- parties view the benefits of litigating in the English courts as only partly related to the automatic recognition and enforcement of English court judgments under the recast Brussels Regulation.

In addition, on 1 January 2021 the UK will accede to the Hague Convention on Choice of Court Agreements in its own right (the EU is already bound). The reciprocal recognition of jurisdiction agreements and enforcement of judgments provided by the Hague Convention is much narrower in scope than that provided by the Brussels Regulation – it broadly only applies to mutual exclusive jurisdiction clauses and judgments arising from them. However, for disputes relating to loan agreements entered into on or after 1 January 2021, this will provide an alternative reciprocal framework between the English courts and those in the EU27 that is not reliant on any UK/EU agreement. This may encourage lenders to start including mutual exclusive English court jurisdiction clauses in loan agreements with EU27 borrowers, rather than asymmetric jurisdiction clauses, from the beginning of 2021.

For more information see Civil justice co-operation: what happens from 1 January 2021.

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