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FINANCING ARRANGEMENTS AND DOCUMENTATION: CONSIDERATIONS AHEAD OF BREXIT

To Our Clients and Friends:

Since the result of the Brexit referendum was announced in June 2016, there has been significant commentary regarding the potential effects of the UK's withdrawal from the EU on the financial services industry.

As long as the UK is negotiating its exit terms, a number of conceptual questions facing the sector still remain, such as market regulation and bank passporting. Many commentators have speculated from a 'big picture' perspective what the consequences will be if / when exit terms are agreed. From a contractual perspective, the situation is nuanced. This article will consider certain areas within English law financing documentation which may or may not need to be addressed.

Bank passporting

The EU "passporting" regime has been the subject of much commentary since the result of the Brexit referendum. In short, in some EU member states, lenders are required under domestic legislation to have licences to lend. Many UK lenders have relied on EU passporting (currently provided for in MiFID II), which allows them to lend into EU member states simply by virtue of being regulated in the UK (and *vice versa*).

The importance for the economy of the passporting regime is clear. Unless appropriate transitional arrangements are put in place to ensure that the underlying principle survives, however, there is a risk that following Brexit passporting could be lost. Recent materials produced by the UK Government suggest that the loss of passporting may be postponed from March 2019 until the end of 2020, although financial institutions must still consider what will happen after 2020 if no replacement regime is agreed. The UK Government has committed to legislate (if required) to put in place a temporary recognition regime to allow EU member states to continue their financial services in the UK for a limited time (assuming there is a "no deal" scenario and no agreed transition period). However, there has not to date been a commitment from the EU to agree to a mirror regime.

Depending on the outcome of negotiations on passporting, financial institutions will need to consider the regulatory position in relation to the performance of their underlying financial service, whether that is: lending, issuance of letters of credit / guarantees, provision of bank accounts or other financial products, or performing agency / security agency roles. Financial institutions may need to look to transfer their participations to an appropriately licensed affiliate (if possible) or third party, change the branch through which it acts, resign from agency or account bank functions, and/or exit the underlying transaction using the illegality protections (although, determining what is "unlawful" for these purposes in terms of a

lender being able to fund or maintain a loan will be a complex legal and factual analysis). More generally, we expect these provisions to be the subject of increasing scrutiny, although there seems to be limited scope for lenders to move illegality provisions in their favour and away from an actual, objective illegality requirement, owing to long-standing commercial convention.

From a documentary perspective, it will be necessary to analyse loan agreements individually to determine whether any provisions are invoked and/or breached, and/or any amendments are required. For on-going structuring, it may be appropriate for facilities to be tranched – such tranches (to the extent the drawing requirements of international obligor group can be accurately determined ahead of time) being "ring-fenced", with proportions of a facility made available to different members of the borrower group and to be participated in by different lenders – or otherwise structured in an alternative, inventive manner – for example, by "fronting" the facility with a single, adequately regulated lender with back-to-back lending mechanics (e.g. sub-participation) standing behind. In the same way, we also expect that lenders will exert greater control – for example by requiring all lender consent in all instances - on the accession of additional members of the borrowing group to existing lending arrangements in an attempt to diversify the lending jurisdictions.

Derivatives

If passporting rights are lost and transitional relief is not in place, this could have a significant impact on the derivatives markets. Indeed, without specific transitional or equivalence agreements in place between the EU and the UK, market participants may not be able to use UK clearing houses to clear derivatives subject to mandatory clearing under EMIR. Additionally, derivatives executed on UK exchanges could be viewed as "OTC derivatives" under EMIR and would therefore be counted towards the clearing thresholds under EMIR. Further, derivatives lifecycle events (such as novations, amendments and portfolio compressions) could be viewed as regulated activities thereby raising questions about enforceability and additional regulatory restrictions and requirements.

In addition to issues arising between EU and UK counterparties, equivalence agreements in the derivatives space between the EU and other jurisdictions, such as the United States, would not carry over to the UK. Accordingly, the UK must put in place similar equivalence agreements with such jurisdictions or market participants trading with UK firms could be at a disadvantage compared to those trading with EU firms.

As a result of the uncertainty around Brexit and the risk that passporting rights are likely to be lost, certain counterparties are considering whether to novate their outstanding derivatives with UK derivatives entities to EU derivatives entities ahead of the exit date. Novating derivatives portfolios from a UK to an EU counterparty is a significant undertaking involving re-documentation, obtaining consents, reviewing existing documentation, identifying appropriate counterparties, etc.

EU legislation and case law

Loan agreements often contain references to EU legislation or case law and, therefore, it is necessary to consider whether amendments are required. One particular area to be considered within financing documentation is the inclusion of Article 55 Bail-In language[1]. In the last few years, Bail-In clauses

have become common place in financing documentation, although they are only required for documents which are governed by the laws of a non-EEA country and where there is potential liability under that document for an EEA-incorporated credit institution or investment firm and their relevant affiliates, respectively. Following withdrawal from the EU, the United Kingdom will (subject to any transitional or other agreed arrangements) cease to be a member of the EEA and therefore English law governed contracts containing in-scope liabilities of EU financial institutions may become subject to the requirements of Article 55. Depending on the status of withdrawal negotiations as we head closer to March 2019, it may be appropriate as a precautionary measure to include Bail-In clauses ahead of time – however, this analysis is very fact specific, and will need to be carefully considered on a case-by-case basis.

Governing law and jurisdiction

Although EU law is now pervasive throughout the English legal system, English commercial contract law is, for the most part, untouched by EU law and therefore withdrawal from the EU is expected to have little or no impact. Further, given that EU member states are required to give effect to the parties' choice of law (regardless of whether that law is the law of an EU member state or another state)[2], the courts of EU member states will continue to give effect to English law in the same way they do currently. Many loan agreements customarily include 'one-way' jurisdiction clauses which limit borrowers/obligors to bringing proceedings in the English courts (rather than having the flexibility to bring proceedings in any court of competent jurisdiction). This allows lenders to benefit from the perceived competency and commerciality of the English courts as regards disputes in the financial sector. Regardless of the outcome of the Brexit negotiations, such clauses are likely to remain unchanged due to the experience of English judges in handling such disputes and the certainty of the common law system.

It is possible that the UK's withdrawal will impact the extent to which a judgement of the English courts will be enforceable in other EU member states. Currently, an English judgement is enforceable in all other EU member states pursuant to EU legislation[3]. However, depending on the withdrawal terms agreed with the EU, the heart of this regulation may or may not be preserved. In other words, English judgements could be in the same position to that of, for example, judgements of the New York courts, where enforceability is dependent upon the underlying law of the relevant EU member state; or, an agreement could be reached for automatic recognition of English judgements across EU member states. In the same vein, the UK's withdrawal could also impact the enforcement in the UK of judgements of the courts of the remaining EU member states.

Conclusion

Just six months ahead of the UK's 29 March 2019 exit date, there remains no agreed legal position as regards the terms of the UK's withdrawal from the EU. It is clear that, for so long as such impasse remains, the contractual ramifications will continue to be fluid and the subject of discussion. However, what is apparent is that the financial services sector, and financing arrangements more generally, are heavily impacted and it will be incumbent upon contracting parties, and their lawyers, to consider the relevant terms, consequences and solutions at the appropriate time.

[1] Article 55 of the Bank Resolution and Recovery Directive

[2] Rome I Regulation

[3] Brussels I regulation.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Global Finance practice group, or the authors:

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