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Upcoming EU restrictions on contractual auditor controls: implications for loan documentation

Lenders seek to monitor their borrower's performance over the lifetime of a lending transaction. Fundamental to this is an analysis of a borrower's audited annual accounts. These are helpful only if properly audited and lenders frequently seek to control the auditor's identity by using so called auditor clauses, particularly on riskier credits. These give lenders comfort as to the quality of the auditors and typically require the borrower to use either specified audit firms or one otherwise approved by the lenders. Upcoming EU legislation will mean that such clauses in their current form will be banned and become unenforceable. This briefing examines the ban and considers the likely consequences for loan facility documentation.

Context and status of the EU legislation

The ban on auditor clauses forms a small part of a much larger EU reform of the statutory audit process which has been driven by perceived weaknesses in that process which were felt to be highlighted by the financial crisis. From a syndicated lending perspective however, it is the prohibition on auditor clauses which is of key importance.

The measures have been approved by the European Parliament and adopted by the EU Council. They will become official EU legislation when published in the Official Journal (expected in the second quarter of this year).

The ban

Any contractual provision which restricts an entity's choice of auditor to "*certain categories or lists of statutory auditors or audit firms*" will be null and void when the relevant legislation becomes effective. Importantly, the ban will apply to *all* contracts and not just those entered into after the legislation becomes effective. There will be no grandfathering and the ban will apply to existing as well as subsequent transactions.

There are two separate (but very similar) restrictions contained in complementary pieces of EU legislation. The important difference between the two is the type of entity to which they apply and how, and when, the ban comes into effect.

Key issues

- Upcoming EU legislation means that market standard forms of restriction on a borrower's choice of auditor will become null and void, probably during 2016 (but possibly earlier)
- There is no grandfathering and the ban will apply to existing as well as subsequent transactions
- The extent to which auditor restrictions could be recast to comply with the upcoming ban is questionable
- The ban may trigger events of default in existing facility documentation

All audited entities – EU Directive – prohibition effective when nationally implemented – required by Q2 2016

An EU directive will require EU states to use their national law to apply the ban to contracts entered into by any entity that is required to be audited. States will probably be required to do this by the second quarter of 2016. (The directive will require implementation within 2 years of its official publication (expected before the end of June this year.)) The exact timing, and nature, of the ban in any EU state will be a function of the national legislation, not the directive itself. Importantly, an individual state may choose to implement the ban ahead of the 2016 deadline.

This element of the upcoming EU legislation is likely to be the most relevant for auditor clauses in loan facility documentation.

Public-interest entities – EU Regulation – prohibition effective in Q2 2017

An EU regulation will apply to contracts entered into by listed companies, credit institutions and insurance companies (referred to as "*public-interest entities*"). The ban will apply automatically throughout the EU (without the need for national legislation) and is likely to become effective in the second quarter of 2017. In addition to the ban itself, such entities will be obliged to report any attempt by lenders to impose a banned auditor clause (or otherwise improperly influence the choice of auditor) to the relevant national authorities.

These entities are likely to be investment grade credits and as such are less likely as a commercial matter to be subject to auditor clauses in their loan documentation. Accordingly this element of the legislation is likely to be less relevant in the ordinary course. It will though need to be considered if the specifics of a transaction with such an entity envisage an auditor clause.

Impact on loan facility documentation

Market standard auditor clauses in non-investment grade loan documentation (such as that published by the Loan Market Association in its recommended form of leveraged facilities agreement) typically operate by reference to lists and/or categories of auditor. Much of the detailed working of the ban will depend on the national implementing legislation and the application of that legislation to cross-border transactions will need particular consideration. However, it is inescapable that such clauses in both existing and future transactions will become null and void when the laws come into effect (likely in 2016 if not before). Lenders and borrowers should consider the implications for both new and existing transactions.

New transactions

When documenting new transactions lenders should be aware that the traditional forms of auditor clause are likely to become unenforceable during the course of 2016 (if not before). Lenders may wish to consider exploring the extent to which their contractual controls on the borrower's choice of auditor could be recast to comply with the upcoming ban. This is unlikely to be a straightforward exercise but approaches that could be considered include:

- Requiring the borrower to appoint a single specified auditor;
- Requiring the borrower to appoint only an auditor which has been approved in advance by the lenders; and
- Making the appointment of an auditor that has not been approved in advance by the lenders a mandatory prepayment event.

None of these is a silver bullet. Firstly each of these approaches is more onerous for borrowers than the current market standard and is likely to be more difficult for lenders to persuade a borrower to agree to. Secondly although they less obviously operate by reference to "*certain categories or lists of statutory auditors or audit firms*" there is a clear risk that each of these approaches might be interpreted as operating as such, and so be rendered null and void by the legislation. Thirdly, the reporting requirement in the EU Regulation may act as a deterrent to any such creativity if the borrower is a "*public-interest entity*". For a lender anxious to retain contractual control over the borrower's choice of auditor however, a provision along the lines of the above might be the best available option.

Existing transactions

Lenders and borrowers should be aware that market standard forms of auditor clause in existing deals are likely to become unenforceable during the course of 2016 (or potentially earlier). There are two key implications:

- Lenders will lose their contractual control over the borrower's choice of auditor when the borrower's obligation to appoint specified auditors becomes null and void.

- Loan agreements typically protect the lenders against subsequent invalidity of the borrower's obligations by triggering an event of default upon that invalidity (either expressly or through a repeating representation). Although the event of default is often qualified by reference to materiality, such provisions could be triggered when the legislation implementing the ban takes effect.

Accordingly, lenders and borrowers are likely to want to consider the extent to which they wish to amend their documentation on existing transactions to address these issues.

A postscript – last year's UK Competition Commission proposals on auditor clauses

Keen followers of the fluctuating fortunes of auditor clauses at the hands of the authorities may recall that the UK Competition Commission (now the Competition and Markets Authority) last year announced plans to restrict the use of such clauses in new contracts to those which employed "*objectively justified auditor selection criteria*". In light of the subsequent EU legislation the Competition and Markets Authority will undertake a further round of consultation on its proposal in the third quarter of this year.

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