SECONDARY LOAN TRADING – IMPLICATIONS OF PROPOSED EU REGULATION ON ASSIGNMENTS

The European Commission has adopted a legislative proposal laying down new conflict of laws rules designating which national law applies to determine who has the superior title to an assigned claim. Subject to three exceptions, the relevant law would be that of the assignor's "habitual residence". If adopted, this would cut across existing loan market practice, which looks to the governing law of the underlying debt on these matters, would lead to an increase in settlement times whilst the perfection requirements in the habitual residence of the assignor are investigated and complied with, and would bring additional costs.

Key issues

- New EU rules on who owns an assigned claim will impact secondary loan market
- The law of the assigned claim continues to be applicable for contractual matters but the law of the "habitual residence" of the assignor will apply to resolve disputes over ownership of an assigned claim
- Additional perfection steps based on the assignor's "habitual residence" will increase costs and settlement times for secondary loan trades
- The proposal is in the form of a Regulation and is currently being considered by the EU Parliament and Council. The Commission has invited feedback until 23 May 2018
- The UK Government will not be bound by the Regulation unless it expressly opts-in to it.

The Commission's Proposal

Objective

The objective of the proposed Regulation (COM(2018) 96 final) is to "help to increase cross-border transactions in claims by providing legal certainty through the adoption of uniform conflict of laws rules at Union level". This proposal is part of the Commission's 2015 Action Plan on Capital Markets Union. The main drivers are to create certainty for the cross-border assignment of receivables in factoring transactions (where a bundle of receivables involving several different jurisdictions and which are due at future dates is assigned to the assignee for immediate cash) and the cross-border assignments of claims as collateral (where claims are assigned by way of security for a loan). The applicable law for determining the third party effects of those assignments is inconsistent across EU member states. By imposing a single connecting factor, the habitual residence of the assignor, the Commission is seeking to create legal certainty and reduce the costs associated with these cross-border assignments. Assignments of claims in the secondary loan market are not expressly mentioned in the Commission's proposal nor its impact assessments.

The new conflicts rule

The Rome I Regulation (Regulation (EC) 593/2008) has already harmonised conflict of laws rules across the EU with regard to purely contractual issues arising out of the assignment of a claim. Rome I provides that (a) the

relationship between assignor and assignee should be determined by the law of the contract of assignment and (b) the relationship between the assignee and the underlying debtor should be determined by the law applicable to the underlying debt (article 14). The Commission's proposed Regulation will not affect these matters. The Commission's proposal is only addressed to disputes with third parties over the ownership of an assigned claim in primarily two situations:

(i) if the same claim has been assigned to different assignees (purchasers); and

(ii) if the assignor (seller) becomes insolvent, the assignor's creditors may assert that the assignment of the claim was not effective, the assignee did not therefore acquire ownership of the claim and the claim therefore remains an asset in the assignor's insolvency.

The proposal in the Regulation is for a general rule that the law of the country where the assignor has its "habitual residence" (whether or not within the EU) will apply to determine the ownership of claims in disputes of the type described in (i) and (ii) above (subject to three exceptions – see below).

"Habitual residence"

"Habitual residence" is defined in the proposed Regulation as "the place of central administration" of the assignor. This was chosen as the connecting factor in preference to the law of the assigned claim or the law of the assignment contract because, according to the Commission, it gives greater predictability for the following reasons:

(i) the habitual residence of the assignor is readily ascertainable by third parties (such as creditors of the assignor) whereas such third parties will have no way of knowing which governing law applies to the underlying claim or the assignment contract. Parties to the assignment would also know in advance of their assignment contract which country's laws need to be complied with to ensure the acquisition of legal title to the claim as against third parties;

(ii) where multiple cross-border claims are assigned (such as in factoring), only the perfection requirements in the assignor's jurisdiction of habitual residence need to be complied with to ensure the acquisition of legal title to the claim as against third parties as opposed to investigating the requirements under all relevant laws; and

(iii) it is consistent with the conflict of laws rules in the EU Insolvency Regulation (Regulation (EU) 2015/848) which designates the law applicable to the assignor's insolvency proceedings as being where the assignor has its "centre of main interests".

In relation to this third point, although the Commission asserts that this is a consistent approach, the terminology is different. It is not self-evident that the "centre of main interests" will always correspond to the "habitual residence" of the assignor. Further, "habitual residence", like "centre of main interests" may not always be readily ascertainable. It may not, for example, always equate to the assignor's jurisdiction of incorporation. In addition, the EU Insolvency Regulation will not necessarily be applicable to the assignor in the context of a secondary loan trade if, for example, as is likely, the assignor is a bank or other regulated entity to which different rules apply.

Potential Impact on Secondary Loan Market

The proposed Regulation applies to "assignments" of claims. The term "assignment" is defined in the proposed Regulation as meaning "*a voluntary transfer of a right to claim a debt against a debtor. It includes outright transfers of claims, contractual subrogation, transfers of claims by way of security and pledges or other security over rights*".

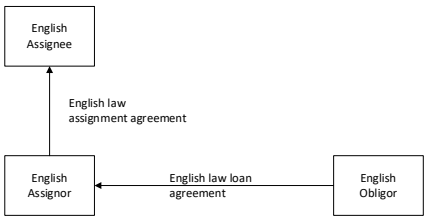
Loans are traded by way of assignment in the secondary loan market using LMA recommended secondary debt trading forms of assignment covering bank debt and distressed claims (for example see the stand alone form of LMA Assignment (Bank Debt)). In these documents, the assignor's *rights* under the Facility Agreement and/or to claim in the Borrower's insolvency are assigned to the assignee. While, in these forms of assignment, the assignee agrees with the assignor to perform and comply with the assignor's obligations vis à vis the other finance parties, this falls short of a full transfer or novation of *all rights and obligations* of the assignor.

Loans are also traded using the form of Assignment Agreement and/or Transfer Certificate mechanism scheduled to LMA recommended forms of Facility Agreement. These are used when the intention is for all of the seller's *rights and obligations* to be transferred in their entirety to the purchaser so that the purchaser becomes the lender of record under the Facility Agreement and the seller ceases to have rights and obligations. Broadly a transfer of rights using the LMA form of Assignment Agreement is expressed as an assignment of the seller's rights under the Facility Agreement together with a corresponding release and assumption of obligations. A transfer using the LMA form of Transfer Certificate is expressed as a transfer by novation of the seller's rights and obligations under the Facility Agreement.

It appears from both the Explanatory Memorandum to the proposal and its Impact Assessment that the new conflict rules are not intended to apply to the transfer of contracts in which *both rights (or claims) and obligations* are involved or the novation of contracts including such rights and obligations. This would suggest that the new conflict rules would not apply to proprietary disputes in respect of the ownership of debt claims that were transferred using the form of Assignment Agreement and/or Transfer Certificate mechanism scheduled to LMA recommended form Facility Agreements but would apply if the assignment has been carried out using the LMA recommended secondary debt trading forms of assignment covering bank debt and distressed claims. However, the definition of "assignment" in the proposed Regulation is extremely wide and on the face of it may also capture assignments carried out using the Assignment Agreement mechanism in the LMA recommended Facility Agreements. A transfer using a Transfer Certificate however is more likely to fall outside of the scope of the new conflict rules. Clarification from the Commission and in the proposed Regulation on this would be helpful.

In the context of assignments of debt claims carried out using LMA secondary loan trading forms of assignment, if this new conflict of law rule applies, it would constitute a significant change in market expectations as to the law that would be applied to resolve proprietary disputes in respect of the claim. The market would now ordinarily look to the law of the underlying debt claim (being the governing law of the facility agreement). If the law of the habitual residence of the assignor is applicable to conflicts involving third parties, in addition to ensuring, as now, that the assignment is effective under the governing law of the underlying debt claim, the assignee would also need to ensure its effectiveness under the law of the assignor's habitual residence.

Example 1 – Competing Interests



English assignor assigns a "claim" under an English law loan agreement to an English assignee. A Belgian company asserts that the "claim" was also assigned to it and that it is therefore the owner of the claim. The parties to the assignment would expect English conflict laws to apply to resolve this dispute on the basis that the underlying claim is governed by English law. Under the Commission's proposal, English law would continue to apply to resolve this dispute, assuming the "habitual residence" of the assignor is England.

This would introduce additional costs (which may be significant) in obtaining advice on the perfection requirements in the jurisdiction of the habitual residence of the assignor. These costs may, in a worst case scenario, make the transaction uneconomic. Settlement times will also be impacted whilst advice is sought. Alternatively, market participants may ignore the new rules which is not ideal either.

It is also of note that a single claim arising out of a syndicated loan agreement may be sold by way of assignment in the secondary loan market a significant number of times on a cross-border basis. The habitual residence of each assignor in the chain could well be different. This proposed conflict of law rule would therefore add complexity to a chain of assignments, which currently only looks to the law of the underlying claim for all matters. Similarly, a single assignee may take an assignment of the same syndicated loan from two assignors who do not have the same "habitual residence" (for example where a sale is conducted by a fund, the sale may be settled by multiple sub-funds). Instead of having only to consider the law of the underlying claim, the assignee would, in addition, need to perfect each assignment in the jurisdiction of the habitual residence of each assignor. Assignors with less complex perfection requirements under the law of their habitual residence may become more attractive sellers. This again adds complexity to assignments of loans in the secondary loan market.

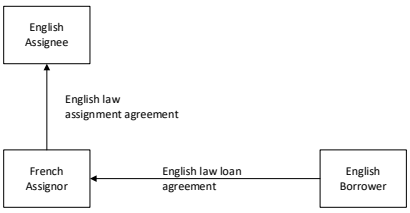
Exceptions

The proposed Regulation contains three exceptions to the "habitual residence" rule. The scope of these exceptions is unclear but they are expressed as covering: assignments by account holders of cash credited to an account in a credit institution; assignments of claims arising from a financial instrument (as defined in MiFID II); and assignments of claims in the context of securitisations. In the case of the first two exceptions, disputes over ownership will be resolved according to the law applicable to the assigned claim (i.e. the governing law of the underlying contract from which the assigned claim arises). In the case of securitisation, the relevant law will be the law expressly chosen by the assignor and the assignee to govern these disputes.

These exceptions were introduced because this accords with existing market expectations and practice in those areas. In the context of securitisations, flexibility has been given to enable parties to choose the law that will govern third party disputes. Although the Commission accepted that market practice in securitisations is to look to the law of the assigned claim to resolve disputes over ownership of the claim, the Commission wanted to provide flexibility particularly in smaller securitisations where the parties may not have the resources to carry out due diligence on all of the claims to be assigned but instead prefer only to look to the law of the habitual residence of the single assignor.

Notwithstanding secondary loan market practice and the potential impact on the secondary loan market, no equivalent exceptions have been provided for the trading of loans by way of assignment. In order to maintain the status quo and avoid disruption in the secondary loan market, assignments of claims arising out of loan agreements (syndicated and bilateral) in the secondary loan market would also need to be given the benefit of an exception that the law of the assigned claim applies to resolve disputes of a proprietary nature.

Example 2 – Insolvency of Assignor



French assignor assigns a "claim" under an English law loan agreement to an English assignee. A French creditor of the insolvent French assignor asserts that the "claim" was not validly assigned to the assignee as a matter of French law. Currently the parties would expect disputes over who owns the claim to be resolved under English law as the law of the underlying claim. Under the proposed Regulation, courts in EU member states must instead apply French law (as the law of the place of the "habitual residence" of the assignor). Therefore, in addition to ensuring the assignment is valid as a matter of English law, the assignee must perfect the assignment under French law to avoid a successful challenge from the French creditor.

What next?

On 12th March 2018, the proposal was adopted by the Commission and put forward for adoption by the EU Parliament and Council in the form of a Regulation. The Commission has invited interested parties to submit feedback to the Commission on the proposal and accompanying impact assessment by 23rd May 2018. The text of the Regulation, impact assessment and feedback information can be found here. A summary of all feedback received will be presented to the EU Parliament and Council to inform the legislative debate.

The date of application of this Regulation, if passed, is stated in the proposal as being 18 months after its entry into force. It is unclear at this stage how long the legislative debate within the EU will take and therefore when the Regulation will enter into force. However, the Regulation makes clear that its provisions will only apply to assignments of claims concluded on or after its date of application. It will not therefore apply to assignments of claims already in place before that date.

As a Regulation, it will be directly applicable in all member states except Denmark and, in the case of the UK and Ireland, only if they expressly opt-in to it. Article 3 of Protocol 21 to the Treaty on European Union gives the UK three months from a proposal being presented to the Council to opt in. It is unclear at this stage whether the UK will opt into this Regulation.

If the UK does not opt-in, it will not be bound by the Regulation, if and when it comes into force. If the UK chooses to opt in to the Regulation, the position is complicated by the UK's scheduled withdrawal from the EU on 29 March 2019. The current political agreement is for a transition period running to the end of 2020 during which for most purposes EU law will continue to apply as if the UK continued to be a member state of the EU. If the Regulation comes into force during the transition period and the UK has opted-in to it, the UK would become bound by its provisions until such time as the UK decides on the extent to which it will continue to apply the EU acquis following withdrawal from the EU. If, however, the application date of the Regulation is after the end of the transition period, the UK would not be bound to apply it notwithstanding its opt-in.

The proposed Regulation is intended to create certainty over the proprietary effects of assignments of claims across the EU given the current inconsistency of national conflicts of laws rules. In the context of assignments of claims in factoring transactions or as collateral/security, this may be helpful. However, new and different conflict of laws rules are unnecessary and unhelpful in the context of the secondary loan market, not least because the proposed change would not align with current expectations of market participants that the governing law of the assigned claim would apply to resolve disputes over who has superior title to that claim. The proposed Regulation in its current form has the potential to disrupt a fully functioning and thriving cross border European secondary loan market by creating new problems for that market, disrupting settlement times, making cross-border assignments of these claims more complex and more costly. This would be contrary to the Commission's stated aims for the proposed Regulation.

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