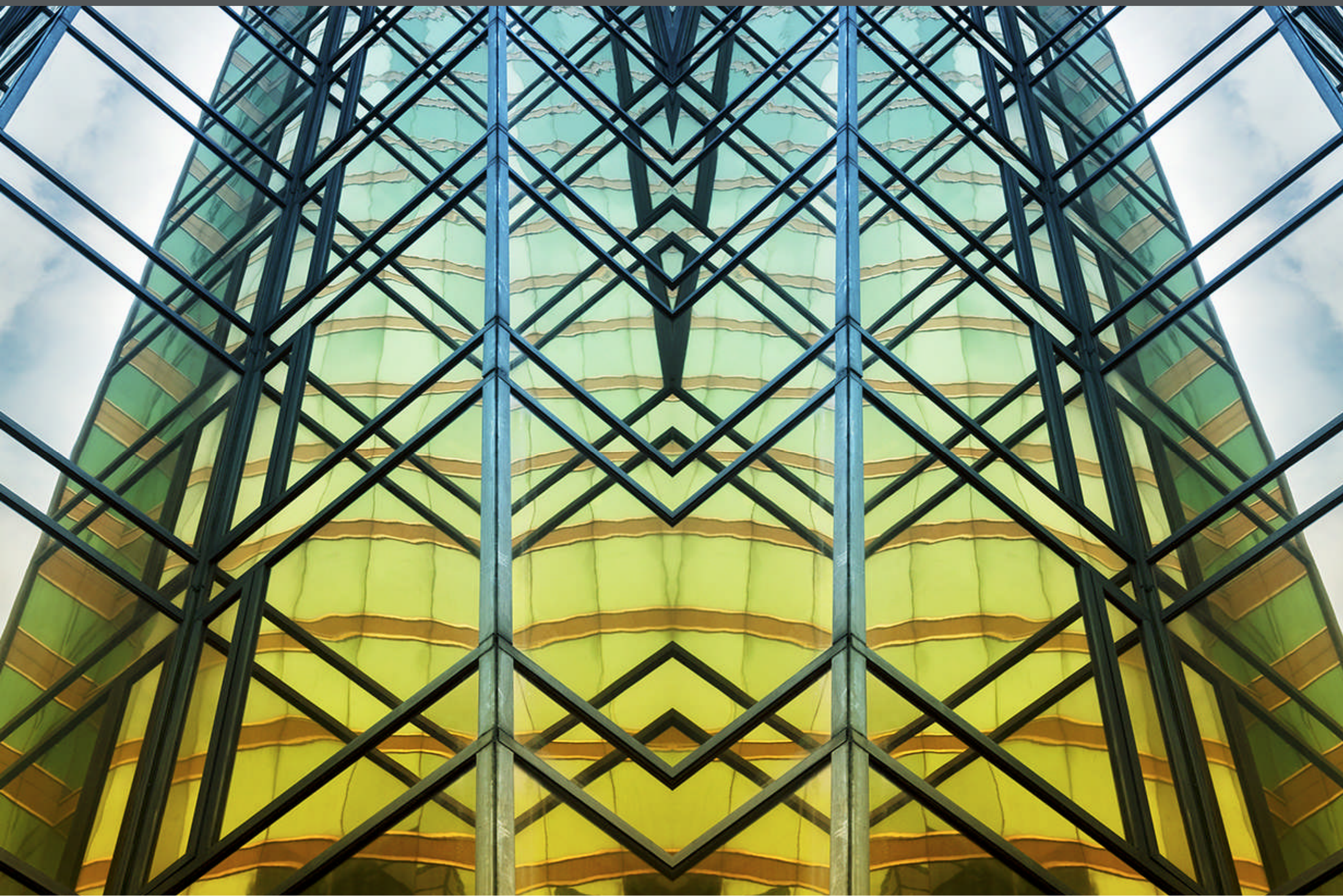
ADDLESHAW GODDARD

December 2015

# Q4 CORPORATE BORROWER UPDATE



# INTRODUCTION

Welcome to the Q4 2015 edition of the Addleshaw Goddard Corporate Borrower Update.

It's that time of year again – just when thoughts might otherwise turn to the holiday season, the transaction timetable moves into fifth gear as advisors and clients alike try to close deals prior to the Christmas break!

There are some clear trends in the deals that we are currently seeing. One of those is an ever-increasing proportion of negotiation time being centred around sanctions wording. This is the case both on cross-border deals for large conglomerates (as you might expect) but also on smaller UK-centred deals in the mid-market. From page 1 onwards, we look at some of the main issues for borrowers to think about in relation to sanctions and how a balance may be struck between protection for lenders and day-to-day practicalities for borrowers.

Another trend that is increasingly affecting our borrower clients is the way in which digital innovation is changing the way in which their cash, trade and treasury activities function. From page 4 onwards, we take a closer look at some key aspects of this trend and the main implications for borrowers.

We do hope these articles are of interest – do not hesitate to contact any member of the team (see page 6 onwards) if you would like to discuss. We look forward to working with you over the coming weeks and into 2016.

In any case, have a great, relaxing Christmas and a Happy New Year.

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# SANCTIONS – PROTECTION FOR LENDERS VS PRACTICALITY FOR BORROWERS

## Introduction

Sanctions provisions have become probably the most controversial and negotiated aspect of a corporate loan agreement.

In this article, we discuss the scope of the wording commonly requested by lenders and key points for a corporate borrower to consider to ensure that it is not inadvertently restricting its ability to trade as usual and/or breaching the terms of its loan agreement.

## Why has there been so much negotiation on sanctions?

Lenders (understandably) seek to protect themselves from their borrowers undertaking activities which may be in breach of sanctions or may cause the lender itself to be in breach of sanctions. However, the protection required by lenders has become more onerous following recent high profile cases, where certain banks have been censured and suffered substantial fines as a result of a lack of control over their (and their customers') activities, which have resulted in sanctions being breached.

In the last 12 to 18 months, sanctions provisions in loan agreements have become more comprehensive and wide ranging. Whilst there is no Loan Market Association (**LMA**) drafting or recommended position, most lenders now require the same (or very similar) wording to be included in loan agreements (which, for ease of reference, we will refer to as the **Market Wording**). Lenders are very reluctant to negotiate or water down the Market Wording, unless there is a compelling and unavoidable reason to do so.

It is not unreasonable for lenders to expect borrowers to comply with applicable sanctions. However, the Market Wording is widely drafted and, for some businesses (particularly retailers, global corporates or even UK corporates which trade cross-border), if this wording is adopted unamended, there is the potential for lawful, sanctions compliant "business as usual" trading by a corporate borrower to cause an event of default to occur under a borrower's loan documentation.

## What is meant by "sanctions" for these purposes?

Sanctions can be financial (freezing assets and preventing access to certain financial services), trade restrictions (e.g. a restriction on the supply of arms) or travel restrictions on sanctioned individuals. They can target specified entities and individuals (often those linked to terrorism related activities) or can apply generally in respect of a particular jurisdiction.

For the purposes of the Market Wording, banks usually require borrowers to comply with all sanctions imposed by the relevant authorities of the United States, the United Kingdom, the European Union and the United Nations. Consequently, borrowers may have to comply with a sanctions regime to which they are not legally subject. For example, a borrower in the UK which operates solely in the EU may not legally be required to comply with US sanctions but will be required to do so for the purposes of the loan agreement. Whilst the lists of sanctioned countries and individuals are publicly available, they are very extensive, meaning it can be impractical for borrowers to constantly ensure they are in compliance.

Given the wide definition of sanctions in the Market Wording, many countries would be deemed to be the subject of jurisdiction wide sanctions (**Restricted Countries**), over and above the "usual suspects" of Iran, Syria, North Korea, Libya, Myanmar, etc. Surprisingly, countries such as Lebanon and China are currently the subject of EU sanctions relating to munitions and so being established in, or trading with entities located in, these countries could potentially cause a breach of the Market Wording.

## What does the Market Wording restrict a borrower from doing?

The scope of the Market Wording extends beyond whether a borrower is, or is not, in legal breach of sanctions, whether the proceeds of its loan are being used in a way which would be expected to result in any person being in breach of sanctions or whether the proceeds of trading in breach of sanctions are being used to make payments to the lender.

The Market Wording also prohibits a borrower from being located or established in a Restricted Country, from trading "directly or indirectly" with people and entities located or established in a Restricted Country and from using the proceeds from any transactions with any people or companies in a Restricted Country to make payments to the lender.

Furthermore, the Market Wording applies not just to the borrower and its subsidiaries, but also to its directors, officers and employees.

## How could this affect the ability of a borrower to trade

The wide terminology used in such provisions means that it is important for borrowers to carefully consider the proposed wording and the potential implications on its business. Key points to be aware of are:

- **Extensive sanctions lists** - the list of sanctioned countries and individuals is extensive and a borrower group which itself only trades in the UK and EU may need to be in compliance with more far reaching legislation (for example that of the United States) of which it may have no knowledge, or may not have appropriate compliance procedures to deal with.

- **Restricted Countries** – given the scope of the Market Wording, lawful and sanctions compliant trading with counterparties in Restricted Countries may be prohibited. Our experience from transactions is that this is not usually the intention of lenders (their main concern is trading with countries such as North Korea, Iran, Cuba, Syria, Sudan, Myanmar, etc) and is a result of the Market Wording including some US principles which don't carry over into English law. However, this can be the impact in practice for a borrower if the Market Wording is left unamended.

- **Directors, officers and employees –** as the Market Wording also usually applies to directors, officers and employees, a group which has a global presence or which trades around the world could find itself in breach of the terms of its loan agreement if any one of its employees engages in a transaction (including outside of a work context) with a person located in a Restricted Country. For many borrowers, it will be impractical to have in place appropriate procedures to police this. Therefore, consideration should be given to whether provisions which relate to directors, officers and employees should be qualified by the actual knowledge of the borrower (i.e. to the extent it is not aware that the activity is occurring, it is not in breach).

- **"Directly or indirectly"** - terminology which refers to the proceeds of the loan not being used "directly or indirectly" to fund or facilitate the activities of a sanctions target can be impractical for a borrower to police.

- **Retailers** – for corporate borrowers which are retailers, the Market Wording can pose a particular problem. Assuming that a retailer will not undertake a full "know your customer" check on each person who walks into its shop, then it is likely to be impractical for it to ensure that the Market Wording can be complied with. For example, if a Lebanese person walked into a retail store in London and bought clothes with cash (which is lawful and does not breach sanctions), this would result in a breach of the Market Wording. This is because that retailer has transacted with a person from a Restricted Country (Lebanon being a Restricted Country in light of the fact that there is an arms embargo on Lebanon) and the cash received from the transaction may, indirectly, be used to make payments to the lender.

## What are the consequences?

The key consequence is that non-compliance with the sanctions provisions in a loan agreement will be an event of default, which will allow a lender to request immediate repayment of the loans and, if it chooses to do so, enforce its security.

This can also cause any other loan agreements it has to cross default.

## Summary

Borrowers should always check the sanctions provisions in their loan agreement carefully to ensure that they do not stop them from operating their business as intended (provided, of course, that this business is lawful and sanctions compliant) and that, as a matter of practicality, they are able to comply with the provisions.

To the extent you have any questions with regard to sanctions, please do not hesitate to speak to Richard Oman (richard.oman@addleshawgoddard.com) or any of the AG corporate banking team who can advise you, and to the extent necessary, put you in touch with the our sanctions specialists.

### AG Contact

Richard Oman is a partner in the corporate banking team at Addleshaw Goddard. He acts for lenders and corporate borrowers on a broad range of financing transactions, including corporate refinancings, leveraged finance transactions and real estate finance transactions.

With sanctions having become one of the most negotiated and contentious points on corporate lending transactions, Richard has extensive experience of advising on sanctions provisions in loan agreements and finding solutions which work for both the borrower and the lender, working closely with the firm's sanctions specialists.

# DIGITAL INNOVATIONS

## The rise (and rise) of digital

- Digital innovation is transforming how people do business across various industries today. Increased customer expectation is the major driver of this change: we have become used to using increasingly sophisticated digital applications at work and for leisure; we now expect them to work instantly, efficiently and frictionlessly. The world of financial services is no different.

- To date digital disruption has been slow in corporate lending. Nonetheless changes are emerging to the way corporate borrowers' needs are viewed and served, particularly around the challenges they face in managing the complexities of their cash, trade and treasury activities. Below is a snapshot of a few of the major digital advances in the market today, being some of the frequent hot topics our digital innovation specialists are asked about.

## Blockchain

- Blockchain is the underlying technology behind crypto-currencies, like Bitcoin. Blockchain is a peer-to-peer network system that uses a distributed ledger and advanced encryption protocols to authenticate every transaction entered onto the blockchain. Put simply, it is a sequential log of all transactions (a form of digital, public spreadsheet) that can be monitored and validated by everyone in the blockchain community, but ultimately controlled by no-one.

- Transactions are listed into blocks for entry onto the blockchain. All participants can access the transactions, but they cannot edit them. Each transaction block is verified and enacted in near real time (Bitcoin's blockchain is updated around every 20 minutes or so) through a series of computers performing complex mathematical algorithms designed to check its authenticity. This removes the need for an single intermediary (i.e. a bank) to record and control the transactions.

- Blockchain technology has received a lot of interest (and funding) from across the banking industry, with a myriad of potential use cases proposed. Which of these will stick remains to be seen, but one application creating a lot of noise is the potential for blockchain to disrupt trade finance:

  - **Trade finance is operated traditionally** as a multi-party, paper-intensive process; the potential of blockchain technology is to digitise and authenticate the records in a more efficient way.

  - **In October, Barclays announced a deal with Wave**, a "FinTech" innovator, under which the bank will provide collaborative support for Wave to develop further its blockchain-based trading supply network. Wave's technology looks to connect all participants in international trading supply chains (e.g. carriers, lenders, forwarders, traders etc.) via a decentralised network in order to accelerate and reduce cost of managing international supply chain transactions.

- Several other lenders are investigating how else to use blockchain. For example, blockchain based distributed ledgers are being assessed for use in "smart contracts" when lenders make loans, recording who has borrowed what across a public network. International money/security transfers, syndicated lending and collateral management have also been identified as key areas where blockchain powered ecosystems could be applied.

- **Implications for borrowers:** While banks are reportedly launching blockchain technology solutions for syndicated loans as early as next year, full implementation of viable blockchain-powered products is probably at least five years away. It will happen though. And for borrowers the key benefit of removing intermediaries from traditional loan products will be to improve competition within the industry, leading to, for example, faster access to funds (and repayments), lower costs and more transparent and efficient services.

## Growth of online alternative financing

- The continued ascent of peer-to-business lending and crowd-funding investment platforms, such as Funding Circle, Crowdcube and Kickstarter, is enabling more SME borrowers to finance (or refinance) their activities from outside of the traditional banking systems. By linking lenders and borrowers directly through their online investment platforms, the likes of Funding Circle and Seedrs can typically offer more attractive rates, as well as quicker decision-making and fund access than non-digital lenders.

- A report out this Summer by Misys estimated that a quarter of small and mid-sized corporates are now financing their working capital needs through a combination of traditional bank and non-bank sources. This rise has not gone unnoticed by the banks and traditional lenders, leading some to re-assess their operating models to become more agile and collaborative. For instance:

- **RBS and Santander UK** each signed deals with Funding Circle that will see the banks refer their SME borrower clients to the online platform's alternative funding options if they are turned down for the bank's more traditional finance arrangements.

- **ING bank** announced a tie up with Seedrs, the UK's second-largest equity crowd-funding platform, under which corporate borrowers judged unsuitable for ING's loan products are redirected to Seedrs for potential equity investment opportunities.

- It is expected that this trend will continue, particularly with the up-coming Small & Medium Sized Business (Credit Information) Regulations, which will likely mandate the UK's largest banks to make more referrals.

- **Implications for borrowers:** Client borrowers should be aware of the opportunity to tap into new sources of digitally delivered funding. Supplementing traditional loan products with, for instance, online invoice finance or other asset-based crowd lending could give borrowers' finance directors more financial flexibility, enabling them to obtain and service their debt better in line with their short and long term financing strategies.

## Big data continues to re-engineer risk

- Advances in big data, social analytics and data supply chains are enabling corporate lenders to make decisions about their borrower clients based on richer data sets from more diverse and dynamic sources. Firms are increasingly looking beyond traditional rating agencies' credit scores to supplement and re-engineer their underwriting and risk decisioning process.

- At the frontier are technology-enabled online lending platforms, such as iwoca, Kabbage and Ezbob. These lenders leverage real time data from various online sources, such as the borrower's online trading activity (eBay, Amazon, PayPal), shipping data and VAT records, to generate a unique credit decision within minutes of application.

- Sophisticated data analytic models and software are providing other innovative ways to supplement existing credit risk models. Both traditional and non-traditional lenders are increasingly:

  - **scrutinising borrowers' sales performance and financial management behaviour** to predict the likelihood that they will pay back a loan. Providers like OnDeck and Cloud Lending assess cash flow by accessing client borrowers' online banking, payment processing and accounting data, via software based sources such as Salesforce and QuickBooks;

  - **using behavioural analytics** in order to augment traditional credit scores. For instance, some online lenders score an applicant's mouse movements, time spent reviewing terms and conditions, and even the number of capital letters used during the application process as influencing factors on the client borrower's credit score; and

  - **data-scraping businesses' social media** activities on Facebook, Linked In and Twitter, along with using financial information from their digital friends and followers, as predictive measures of creditworthiness. For example, algorithms can now assess a corporate borrower's social media ratings and reviews, as well as customer comments/replies, to score their sales and customer service performance as part of the loan application process.

- **Implications for borrowers:** A business's financial strengths and weaknesses are becoming more transparent through its digital footprints. Corporate lenders will be tempted to exploit this primarily to reduce credit risk. The more savvy should also use their digital insight to remain engaged; applying the analytics to help fundamentally sound businesses remain liquid during difficult periods. Ultimately, the greatest prospect for big data is to make a lender's loan decisions reflect more accurately their client borrower's financial standing at every point of the loan's term.

## AG Contact

If you require any advice in relation to digital payments or services, please contact David Futter david.futter@addleshawgoddard.com) or your usual Addleshaw Goddard contact.

David is a Managing Associate in the Commercial team, specialising in complex commercial and technology-related transactions, particularly in the financial services, IT and retail sectors. He works within the firm's Digital Innovation Team.

# SENIOR TEAM CONTACTS

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We advise corporate clients on the full range of financing matters.  If you would like to discuss your financing, or any of the issues raised in this update, please contact any of the Addleshaw Goddard individuals listed below.

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*"I admire them for their sector product knowledge. They seem to have a  huge depth of resources to assist with all the connected issues we might have."*

CHAMBERS UK 2016

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*"Advice is pitched at the right level and at a sensible competitive price."*

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