ADDLESHAW GODDARD

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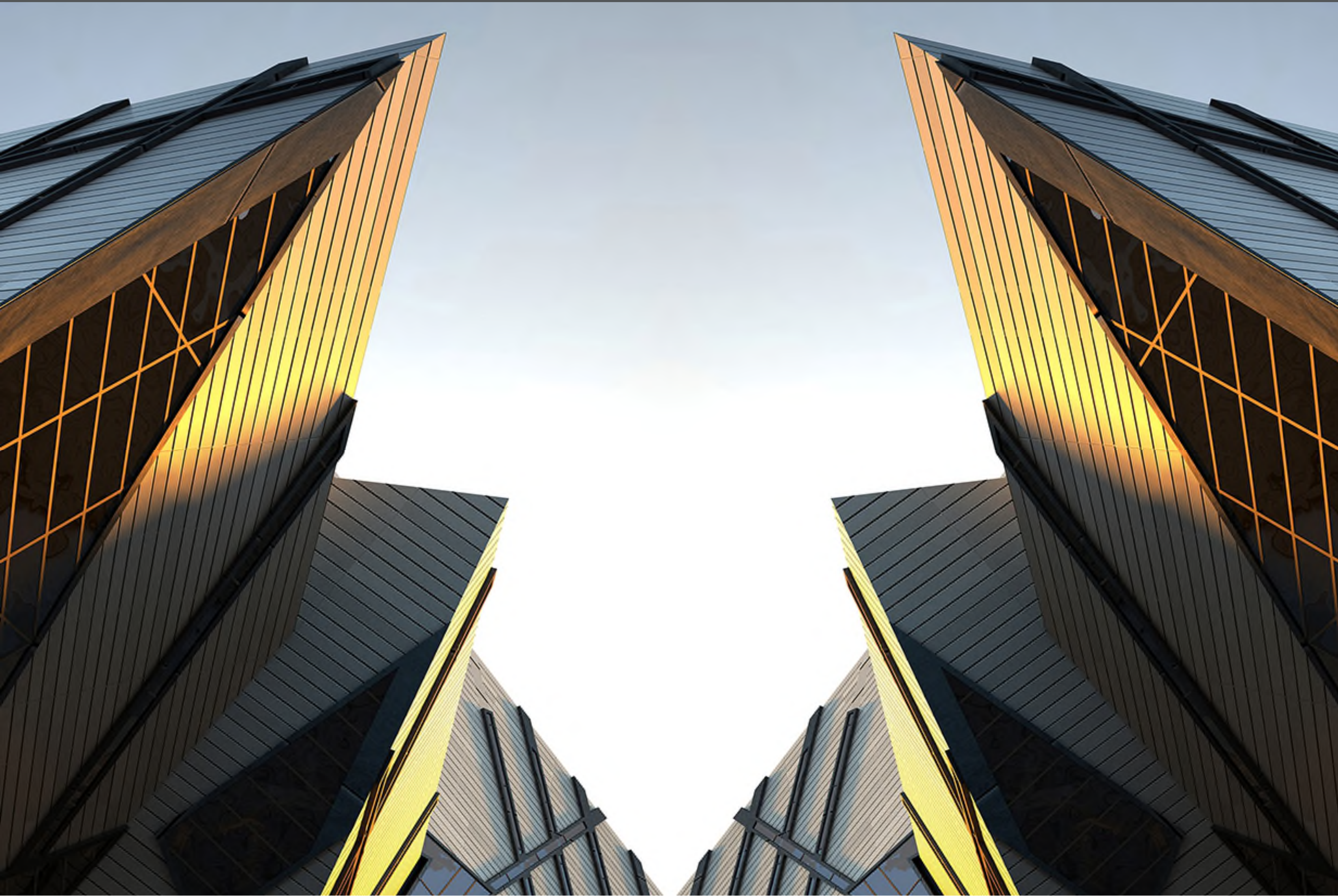
Q1 2016 CORPORATE BORROWER UPDATE



INTRODUCTION

Welcome to the Q1 2016 edition of the Addleshaw Goddard Corporate Borrower Update.

Although event-driven financings (M&A and particularly opportunistic bolt-on acquisitions) are keeping us busy, there is a palpable sense of apprehension in some quarters. This sense of unease emanates from the impending 'Brexit' referendum. For this reason, we thought that it might be of interest generally to take a closer look at the underlying issues, particularly from a legal perspective. We do so from page 2 onwards.

Another (perhaps overlooked) issue on the horizon for borrower (and indeed lender) clients is the change to the accounting treatment of leases under IFRS. These changes impact lessees and lessors applying IFRS and also have the potential to affect financial covenants and other key provisions contained within loan documentation. For this reason, we examine the changes in more detail from page 4.

We do hope these articles are of interest – do not hesitate to contact any member of the team (see page 7 onwards) if you would like to discuss. We look forward to working with you as we move into the Summer months.

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BREXIT

Introduction

The UK electorate faces a decision on 23 June 2016 with potentially significant outcomes for the country in general, and business in particular.

The possibility of the United Kingdom leaving the European Union ("**Brexit**") raises a lot of questions. For example, what exit terms would be negotiated and how long would it take? When the electorate goes to polls, these questions will remain unanswered. Given the potentially far-reaching outcomes of Brexit for the UK, the EU referendum is arguably the most significant decision faced by the UK for some considerable time.

In this article, we consider some of the key issues.

EU/UK – trading relationship

The EU/UK trade relationship is clearly important to the UK economy. The EU accounts for 45% of exports and a further 12% with countries covered by EU free trade agreements (**FTAs**). Services account for 80% of the UK economy and 43% of total exports – the largest share of services exports of any major advanced economy. The EU is also a major source of inward investment into the UK - 46% of the total. The financial services sector employs over a million people in the UK; constitutes over 7% of economic output; accounts for 13% of UK exports and generates a trade surplus of £60bn.

For UK business, retaining access to the single market following a Brexit would be of critical importance.

The New Settlement

EU leaders reached an agreement in Brussels on 18/19 February 2016 on the terms of a new settlement for the UK within the EU. The UK Prime Minister, David Cameron, has described the settlement as "the best of both worlds". The British people will be asked in the referendum to vote on whether they wish to remain in the EU on this renegotiated basis or leave the EU. The key changes to the EU/UK relationship are as follows:

- ***Economic governance*** – there will be a formal recognition that the UK should not be forced to participate in eurozone measures, meaning that non-eurozone countries (including the UK) will not have to pay for or participate in Eurozone bailouts or measures to deepen eurozone integration. On the other hand, the UK (and other non-eurozone countries) will not stand in the way of a deepening eurozone. There will be a formal mechanism enabling non-eurozone countries to object to (but not veto) proposed EU legislation concerning the eurozone that does not respect these principles

- ***Competitiveness*** – there will be measures taken to reduce the regulatory burden for small businesses together with a commitment to fully implement and strengthen the single market and take concrete steps towards better regulation. The EU will pursue FTAs with the world with a renewed commitment. Progress on these matters will be closely monitored and reviewed

- ***Sovereignty*** – the UK will not have to participate in 'ever closer union' or further political integration into the EU. A 'red card' procedure will enable 55% of national parliaments to object to proposed EU legislation on the grounds of non-compliance with the principle of subsidiarity

- ***Welfare and Free Movement*** – the limits and conditions applicable to the Treaty rights of free movement of EU workers and EU citizens are clarified. An 'emergency brake' mechanism will be established to enable a member state to restrict access to in-work benefits for immigrant workers for up to four years in exceptional circumstances (should it be enacted, the 'brake' would be in force for 7 years). A member state may reduce child benefit by indexing such benefits to the EU state where the child lives (dealing with the issue of exported child benefit)

Legally binding?

The EU heads of state have declared that the new settlement will be legally binding. The new settlement will represent an International Law Decision between EU member states which will be registered at the UN as a treaty and recognised as legally binding by EU Council Legal Service. It will require treaty change for the new settlement to have the full force of EU law, which means that whilst the EU Parliament and the European Court of Justice would have to take account of the new settlement, they would not be bound to do so. There is EU precedent for an International Law Decision becoming a protocol to the next treaty negotiations (e.g. Denmark and Ireland).

Process for exit

Article 50 of the Lisbon Treaty sets out the process by which a member state exits the EU. If the UK were to vote in favour of leaving the EU and thereafter give notice (an **Article 50 Notice**) to the European Council of its intention to leave, it will be immediately excluded from the European Council and the Council of Ministers. The remaining 27 EU leaders will appoint 2 members states to negotiate and conclude an agreement with the UK as to its exit. The agreement would set out the arrangements for the UK's withdrawal and the framework for any future relationship.

There is a 2 year deadline to conclude an agreement before the deal is voted on in the European Council using the process of qualified majority voting. The final agreement would need to be approved by the European Parliament.

Importantly, it requires a unanimous decision of the remaining members of the EU to extend the 2 year deadline. The hard deadline to complete exit negotiations obviously gives the negotiating 27 members states leverage in Brexit negotiations.

Disorderly exit – to be avoided

A lot of commentators agree that two years is unlikely to be enough time to negotiate a UK exit from the EU given the complexity of the legal and political issues which would form part of those negotiations. As a practical matter, the UK would also need to run in parallel the negotiation of FTAs with counterparts to the EU's existing FTAs (as the UK would cease to have the benefit of these FTAs on exit).

Indeed some commentators have suggested that the complexity of exit negotiations could mean that, in reality, a full exit, including the negotiation of the necessary trade treaties, could take up to 10 years.

Some have argued that the UK could simply withdraw unilaterally from the EU (for example, by simply repealing the European Communities Act 1972 that gives EU law effect in the UK). Such a unilateral withdrawal would be a breach of both international and EU law and is therefore not an attractive option for the UK government.

A Brexit without a EU/UK deal in place would clearly not be an attractive option. Such a disorderly exit would, for example, create serious issues for the UK's own legal system (as the UK will need to prepare the necessary changes to UK legislation to deal with a Brexit – a huge task in itself) and create business continuity issues for UK businesses whose license to do business in the EU depends on EU legislation (e.g. financial services).

Referendum decision final?

There has been some debate as to whether the UK could delay issuing an Article 50 Notice following a vote to leave whilst negotiation between the EU and the UK took place, with the possibility of a second referendum following those negotiations. Political pressure from within the UK and the EU following a vote to leave might make this a politically difficult option for the UK government regardless of its attractiveness as a negotiating tactic.

Furthermore, invoking Article 50 is seen by the EU as the process by which a member state negotiates to leave the EU rather than a way to improve membership terms.

The best that can be said pre referendum is that there is considerable uncertainty as to what the legal and political outcomes of Brexit could potentially be.

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THE END OF THE OPERATING LEASE – IMPACT FOR LESSORS, LESSEES AND CORPORATE BORROWERS

The International Accounting Standards Board (**IASB**) has recently announced International Financial Reporting Standards 16 (**IFRS 16**) which contains new accounting rules for leases.

IFRS 16 will apply to accounting periods commencing from 1 January 2019 onwards (though early adoption is allowed) and, as well as impacting lessees and lessors, it has the potential to affect financial covenants and other key provisions contained within loan agreements. The impact of these proposed changes will need to be anticipated by all parties in advance of the changes coming into effect, particularly given that many banking facilities being put in place today are likely to still be in place following the implementation of IFRS 16.

The changes do not apply to companies applying UK GAAP nor will these changes be considered for UK GAAP at present.

What are the changes?

Under the current rules (IAS 17), the accounting treatment of leases depends on whether they are classified as "operating" leases (which are treated as a cost to the lessee over the lease period, and whereas they may be noted, do not appear on a company's balance sheet) or "finance" leases (which are recorded as assets and liabilities on the balance sheet).

IFRS 16 dispenses with the distinction between operating and finance leases from the lessee's perspective so all leases will be listed as liabilities in a company's balance sheet.

However the rules only apply to leases as defined in IFRS 16. A lease is defined as any contract where a party has the right to control the use of a specified asset for a specified time period. The rules will not therefore apply to certain services agreements which will not be recognised as leases nor will they require recognition in a company's balance sheet.

Effect on lessees' accounting treatment of leases

Under IFRS 16, the distinction between operating and finance leases will become irrelevant to the lessee, which will be required to record almost all leases in a similar way to finance leases under the existing rules. A lessee will therefore recognise lease assets and liabilities in the balance sheet. The rules will require lessees to consider all leases in place as at 1st January 2019 and recognise them in their balance sheet (including leases previously categorised as operating leases), albeit there are exemptions for leases of less than one year and for low value assets.

For lessees with a large portfolio of operating leases, this could result in a significant increase in a lessee's gross assets and gross liabilities which could, in turn, affect their financial covenants.

In addition, the fact that interest is recorded in the income statement means that reported profit may be affected depending on the lessee's portfolio and each lease's interest profile.

Effect on lessors

The rules change very little for a lessor who will still record operating and finance leases.

Impact for corporate borrowers

IFRS 16 will have various knock-on effects for banking facilities and the ability both for borrowers to comply with financial covenants and other terms of loan documents (and, in particular, loan documents which are based on the Loan Market Association (**LMA**) precedent documentation) and lenders to monitor compliance in the manner envisaged when the facilities were made available.

These effects are both legal and practical and their full extent will depend upon whether the documents provide that financial covenants will be tested on the basis of "frozen GAAP" (i.e. by reference to IFRS accounting principles in place as at the start of the term of the facilities) or "rolling GAAP" (i.e. where updates and changes to IFRS are taken into account).

Uncertainty caused by changes to terminology

References to "finance leases" or "capital leases" (used in the context of financial covenants and permitted financial indebtedness within the LMA documentation) will not have any meaning under IFRS 16. The provisions within LMA documentation which use these terms (and for which frozen GAAP doesn't apply) will therefore lack certainty and could result in disputes in the interpretation of these clauses and whether an Event of Default has arisen (which, in turn, could create uncertainty as to whether the borrower's auditors will be able to sign off their accounts on a going concern basis – auditors are often reluctant to do so when there is an Event of Default continuing).

For example, borrowers and lenders may disagree as to whether all leases are now "finance leases" for the purposes of the documents or, conversely, that no leases should be considered to be finance leases.

However, for the purposes of the remainder of this article, we have assumed that the LMA documentation will be interpreted so that all leases (including those currently classified as operating leases) will be considered to be finance or capital leases.

Rolling GAAP – potential impact on financial covenants

The extent to which the implementation of IFRS 16 could affect a borrower's ability to comply with its financial covenants will depend on whether the loan documentation specified that the covenants are to be measured on the basis of frozen GAAP or rolling GAAP.

If rolling GAAP is used, then following the implementation, financial covenants which have been set in a pre-IFRS 16 context will be measured in the new context. For a business which has significant operating leases, this could have material and detrimental impact on its ability to comply with its financial covenants.

For example, the leverage (or gearing) covenant, which measures profit (usually EBITDA) to debt, will usually take into account the capitalised value of finance leases in calculating the debt figure. Therefore, the capitalised value of leases which were previously operating leases will now be included as debt for these purposes, thereby eating into (or even exceeding) the previously agreed headroom between expected performance and the covenant levels, in a way not envisaged or intended by either the borrower or the lender.

There will be similar impacts for both the Cashflow Cover and the Interest Cover covenants with regard to the interest and/or capital elements (as applicable) of payments under leases previously classed as operating leases.

Fixed GAAP - Impact on financial information provision

Our experience is that in the majority of cases, frozen GAAP is used within loan documents, which means that the changes to the accounting rules are likely to impact more on the financial reporting requirements than financial covenant compliance.

Unless both the bank and the borrower agree to amend the financial covenants in line with IFRS 16 position, this could lead to borrowers being required to prepare two sets of financial statements, one set in line with updated IFRS for the purposes of its audit, any stock exchange requirements and for filing at Companies House, and another set to deliver to its lenders for the purposes of financial monitoring and evidencing financial covenant compliance.

Permitted Financial Indebtedness – impact on the leasing "basket"

If operating leases are reclassified as finance leases, then this will impact on the exception to the usual restrictions on incurring financial indebtedness. Operating leases would not usually be caught by this restriction and a "basket" is usually agreed for finance and capital leases and HP agreements, limiting the amounts which can be outstanding under those arrangements at any time. If current operating leases were to fall within the finance lease basket and, as a result, cause that basket to be exceeded, then this could inadvertently result in an Event of Default occurring, again in a way not envisaged or intended by either the lender or the borrower.

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