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Dear Sirs

THE BUSINESS CONTRACT TERMS (ASSIGNMENT OF RECEIVABLES) REGULATIONS 2017

1 This note has been prepared by a working party of the Financial Law Committee of the City of London Law Society. The members of the working party deal with the issues raised in this note on a day-to-day basis.

2 The City of London Law Society represents approximately 17,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a wide range of consultations on issues of importance to its members through its 18 specialist Committees.

3 The purpose of the note is to explain briefly why we consider that The Business Contract Terms (Assignment of Receivables) Regulations 2017 (the **Regulations**) will create substantial uncertainty and may adversely affect

access to finance for UK businesses if they are adopted. This would be particularly unfortunate at a time when businesses already face substantial uncertainties, and when the focus should be on producing clear, straightforward legislation.

4 The purpose of the new law is primarily to enable small and medium-sized enterprises in the United Kingdom to obtain greater access to finance. It does so by outlawing prohibitions on the assignment of receivables, with the intention that this will make them more attractive to invoice discounters. However, as drafted, the new law appears to undermine other forms of financing (including loans, bonds and structured finance transactions such as securitisations) by making fundamentally important provisions routinely included in the documents for such financings ineffective to the extent they apply to receivables. This cuts across the stated purpose of the Regulations to facilitate access to finance for businesses and the wider policy objective of diversifying finance markets (as set out in the draft explanatory memorandum to the Regulations).

5 The Regulations have been made under Section 1 of the Small Business, Enterprise and Employment Act 2015 (the **Act**). The Regulations have now been laid before Parliament for approval by resolution of each House of Parliament. They do not just apply to small and medium enterprises. They extend to all companies of any size, wherever incorporated.

6 The genesis of the Regulations is unusual. When the Act was passed in 2015, draft Regulations were published shortly afterwards, and there was a brief consultation on them. Nothing then happened for two years. The Regulations were laid before Parliament in September 2017, without any further consultation and in a substantially revised form compared to the initial draft. There was therefore no opportunity to discuss their drafting.

7 Having now studied the Regulations in detail, in our view they will produce substantial uncertainty in the law and may be ultra vires.

Existing Contracts

8 Legislation is not usually retrospective, but the Regulations seem to apply to existing contracts as much as to future ones. It is clear from the consultation in 2015 that this was not the intention at the time, but that intention does not seem to be reflected in the Regulations which have been laid before Parliament. If they are retrospective, this will be unfair on those businesses which have entered into their contractual arrangements on the basis of the current law. A provision which was perfectly effective when the contract was entered into will be rendered ineffective as a result of the Regulations.

Assignment

9 The new law invalidates contract terms which prohibit the assignment of receivables. There are two types of uncertainty in this formulation. The first problem is to understand what amounts to an "assignment" under the Regulations. Receivables are transferred in various ways in practice. Sometimes the transfer is outright (for instance by way of sale); and sometimes it is by way of security (for instance to secure a loan). The transfer may be effected by a statutory assignment, an equitable assignment, a charge or a trust. It is not clear which of these are covered by the new law and which are not, and whether it makes any difference if the transaction concerned is outright or by way of security. The Regulations do not properly cater for the variety of ways in which receivables are transferred.

Prohibition

10 There is also uncertainty concerning the types of clause which are affected by the Regulations. Regulation 2(a) renders ineffective a contract term which prohibits the assignment of a receivable. Regulation 2(b) renders ineffective a term which prevents an assignee from determining the validity or value of the receivable. Regulation 2(c) renders ineffective a term which hinders the assignee's ability to enforce the receivable. We have been reviewing these provisions in the light of the types of transaction we see in practice; and we have been unable to establish with any degree of certainty what they are intended to cover.

11 The new law clearly covers a simple prohibition on assignment. But, in practice, clauses are drafted in a variety of ways and are rarely simple prohibitions. They may prohibit assignments without the consent of the counterparty, or they may prohibit assignments without consent, such consent not to be unreasonably withheld. They may prohibit security assignments but not outright assignments. They may allow assignments if the counterparty consents. They may allow assignments on payment of a small fee, or sometimes a large fee. They may allow an assignment if it does not result in the counterparty having to pay more. Like any business contract, the permutations are many and varied. It is simply not clear which are covered by the Regulations and which are not.

Confidentiality Clauses

12 In business, it is often important that contracting parties should keep the transaction, or certain aspects of it, confidential. Regulations 2(b) and (c) seem to make confidentiality clauses unlawful if they relate to receivables. That may result in parties choosing a foreign law rather than English law.

Negative Pledges

13 Most loan documents contain a clause which restricts the borrower from creating security over its assets. Clauses of this kind are normally referred to as negative pledges. It is also common in many loan agreements to prohibit borrowers from disposing of their receivables. These clauses are important protections for lenders, both in secured and in unsecured transactions. They are also common protections in bond documents.

14 Regulation 2(a) provides that a term in a contract has no effect to the extent that it prohibits the assignment of a receivable arising under that contract **or any other contract**. On the face of it, these words would invalidate a negative pledge and the other protections referred to above to the extent that it restricted the assignment of receivables. That is clearly not the intention, but it may well be the result of the drafting of Regulation 2. This would create material problems in the loan market and in the bond market. The amounts outstanding under existing loan and bond documents which rely on these protections must

run into trillions of pounds.

Share and Business Sales

15 On our reading of the Regulations, share purchase agreements and business/asset sale agreements are out of scope, but there is a lack of clarity in the drafting of the Regulations which means that there is some uncertainty over whether related Transitional Services Agreements (under which a vendor group for a transitional period supplies services (eg IT, record keeping) to the business being sold after the sale until the purchaser has time to set up alternative arrangements) are intended to be caught. These are clearly not the sort of arrangements that should be subject to factoring as they are not standard commercial supply agreements but very much tailored to a particular situation. We believe that the position on all aspects of share and business sale arrangements should be clarified to avoid legal uncertainty.

Ultra Vires

16 There is a further problem. In addition to the uncertainty of regulation 2, there is a concern that it is wider than is authorised by section 1(2) of the Act, and might therefore result in the Regulations being ultra vires. In particular:

- Regulation 2(a) applies to a term in a contract which prohibits the assignment of receivables arising "under that contract or any other contract". This is inconsistent with section 1(2) of the Act which defines a "non-assignment of receivables term" as a term in a contract which prohibits the assignment of receivables arising "under the contract or any other contract between the parties".

- Regulation 2(a) extends to prohibitions on assignment of receivables in any contract, including an excluded financial services contract. This is not consistent with section 1(1) of the Act which provides that regulations may be made in relation to prohibitions on assignment of receivables in

"relevant contracts". "Relevant contracts" are defined in section 1(3) specifically not to include excluded financial services contracts. The limited definition of "receivable" in regulation 1(2) does not assist.

- Regulations 2(b) and (c) appear to extend more broadly than is envisaged by section 1(2) of the Act. The definition of a "non-assignment of receivables term" in section 1(2) extends to terms which prohibit or impose a condition, or other restriction, on assignment. It is not obvious that regulations 2(b) and (c) fit within the definition.

Cross-border contracts

17 English law is a valuable export. Parties all over the world use English law to govern their contracts, largely because English law generally gives effect to the parties' intentions. Because the Regulations will restrict freedom of contract in commercial transactions, they do not apply where English law is chosen by the parties but would not otherwise be the applicable law of the contract (regulation 1(2)(d)).

18 Where a contract is entered into between two foreign parties relating to a transaction abroad, the Regulations will therefore not apply. But many cases are less clear than that. A contract may be entered into between parties, one of whom is in England and the other of whom is not. And the contract may relate to transactions both in England and elsewhere.

19 The advantage of our conflict of laws rule is that the choice of the parties is determinative for practically all purposes. When the Regulations are in issue, it will be necessary to go behind the choice of law and to discover whether English law would have applied if the parties had not chosen it. There are rules in the Rome 1 Regulation which provide what is to happen in this case, but their application in particular cases is not always clear. Most business contracts contain a choice of law clause to avoid the problem of what the law would be otherwise. The Regulations take us back to this problem. That will result in unnecessary uncertainty and expense and might act as a disincentive to choosing English law. These provisions were not included in the 2015 draft or

proposed in the Government response to that consultation and have therefore not been the subject of consultation.

20 In addition Regulation 2(c) could potentially require that the court not give effect to a choice of court or arbitration clause where the forum would be outside of England and Wales or Northern Ireland on the grounds that would impede the assignee's ability to enforce the receivable. This would be a very significant over-ride of the UK's present commitments in private international law, which should not be embarked upon without full consideration of its potential impact and carefully checking that there is no breach of the UK's international obligations under the treaties on choice of court and on arbitration binding on the UK.

Protecting the payer

21 The effect of the Regulations is to override an agreed term in a business contract in favour of one of its parties. Naturally enough, the disadvantaged party will try to avoid the consequences if they might be adverse. As far as the payer of the receivables is concerned, there are good reasons why non-assignment clauses are popular – one of which being that an assignment will deprive the payer of certain rights of set-off which it would otherwise have. Some financing structures rely on non-assignment clauses to preserve the availability of mutual set-off on insolvency. Those financing structures may be adversely affected by the Regulations.

22 Legislation which attempts to deny businesses the freedom to choose their own contract terms has not been a conspicuous success in the past. The counterparty to the contract will (quite rightly) try to avoid the harsh effects of being denied freedom to contract on agreed terms. This will create uncertainty. This could have been avoided if the legislation had enshrined the principle that the payer should not be worse off as a result of the Regulations.

Conclusion

23 If adopted, the Regulations will create serious uncertainty in a wide range of financial transactions. Any benefit to invoice discounters would be substantially

outweighed by the detrimental effect on other parts of the financial markets. They may also be ultra vires. Either way, they are not a good advertisement for a post-Brexit United Kingdom. The best outcome would be that the Regulations are not approved and that their terms are reconsidered, following proper consultation.

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