ALLEN & OVERY

Legal & Regulatory Risk Note

A risk management briefing on key legal and regulatory issues in the finance sector

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Contents

This PDF has elements of interactivity included

Foreword

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While questions about the likely effects of the pandemic on the fundamentals of day-to-day life, management of the global economy, regulation of the financial system, and the role of the state, will remain; it is clear that financial services have been faced with their greatest test since 2008-2009.

Navigating through the pandemic and managing its aftermath are just some of a number of converging challenges that test resilience. Other changes – such as IBOR transition, climate risk and sustainability, digitalisation, Brexit and heightened political volatility – are continuing to accelerate and converge. But that is not an intrinsically bad thing as all of these catalysts bring opportunity for financial institutions that are well prepared, agile and willing to embrace change.

Many institutions are already addressing these challenges. The need to harness digitalisation as a means of driving efficiency, protecting margins and competing with new market entrants is well understood. Managing the risks arising from climate change, the culture and conduct of the organisation and other issues relating to good governance are becoming more widely recognised as strategic and operational imperatives, that must not be ignored or relegated as challenges for the future.

Put simply, the impact of Covid-19, although it is undoubtedly a significant priority for the financial services sector, should not be allowed to eclipse these other important issues. Planning effectively for the long term by making informed judgements, based on understanding the risks and opportunities that lie ahead in relation to all of these forces of change, will be a significant factor in deciding the winners and losers when we eventually begin to emerge from the pandemic.

It is in light of this wider context that we have compiled the articles featured in this edition of the Risk Note. I hope they provide food for thought, and we look forward to discussing some or all the topics with you.

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Fintech M&A: The future of dealmaking post Covid-19

After a run of high-value deals at the start of the year, fintech M&A has slowed to a trickle. What will dealmaking look like in the future?

For investors in the fintech market, the contrast could not have been more stark.

In the first quarter of 2020, financial institutions, financial sponsors and mature fintech companies generated a series of increasingly high-value deals.

Among them we saw:

- Visa buy fintech start-up Plaid for USD5.3 billion;
- Morgan Stanley acquire E-Trade for USD13bn;
- Worldline buy its payment services rival Ingenico for USD8.6bn; and
- Intuit take over the personal finance portal, Credit Karma, in a USD7.1bn cash deal.

As we enter the final quarter of 2020, the picture has changed.

As the Covid-19 pandemic took hold across the world, fintech transactions went into rapid decline, mirroring the pattern of steeply falling deal activity across almost all sectors and regions.

Listed fintech companies, which had comfortably outperformed the S&P 500 and Nasdaq before Covid-19, were significantly undershooting these indices afterwards. Similarly, those fintechs whose businesses focus on sectors which are hardest hit, such as travel or entertainment, have suffered disproportionately.

In reality, the impact of the crisis on this historically vibrant market is more nuanced. There were noticeable changes in sentiment even before the pandemic.

Traditional banks and financial institutions were already expressing concerns about over-inflated valuations in the sector.

Venture capital funds, which have poured billions of dollars into the sector in recent years, were also taking stock and reining back investment. Indeed, Q1 2020 was the worst quarter for VC fintech investments since 2017.[1]

Against a backdrop of rapidly rising valuations, we were beginning to see potential investors switch to other strategies. With the **Buy** option looking increasingly pricey, the focus was already shifting towards **Build** (developing fintech solutions in-house) and **Collaborate** (forming alliances, or partnering with promising start-ups through joint ventures or, more likely, through minority investing).

1. Source: https://www.cbinsights.com/research/report/fintech-trends-q1-2020/

Read our latest perspectives on the fintech sector here

How have things changed for fintechs?

Valuations are beginning to come down in the short term as the sector swings from a seller's to a buyer's market. But there is little sign yet that price expectations have become truly aligned.

The pressure on high-growth companies to raise new funding has become more intense. Even companies that were close to achieving 'unicorn' (USD1bn valuation) status ahead of the pandemic, have been forced to scale back their ambitions. Others have retreated on expansion plans and announced office closures and redundancies.

The situation is particularly acute for those companies at the very earliest stages of development. The short-term focus for these businesses is on survival. Companies are hunkering down to preserve cash to make it through to the next scheduled fund raise or revenue event.

Where the need for fresh finance is more immediate, we have seen the emergence of so-called 'down rounds', where companies complete a fund raise at a lower valuation to the one used in their preceding financing round.

Historically, down rounds have been rare in key fintech markets, not least in the UK. The change in market dynamics has already started to affect a range of market participants, even well established players.

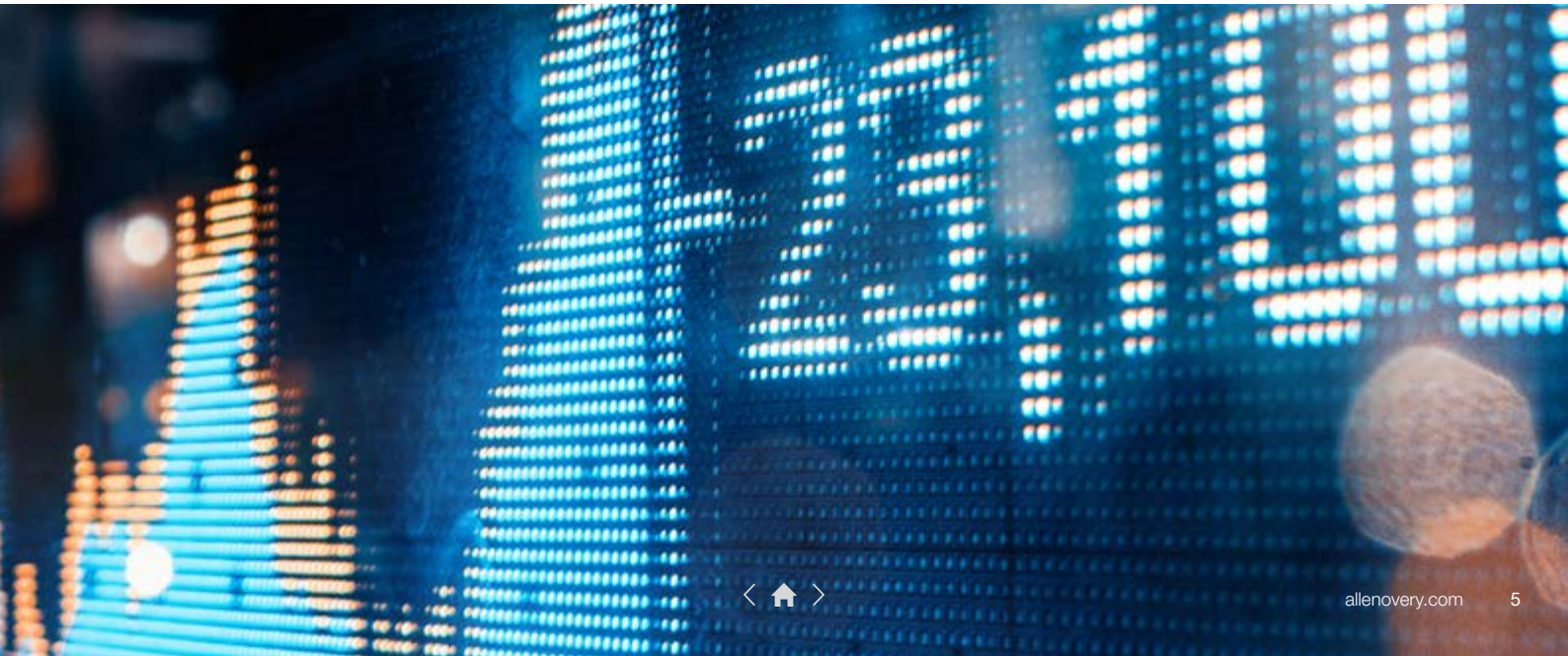
Down rounds are not a comfortable exercise. They are, in PR terms, comparable to a listed company issuing a profits warning. And they can lead to wider problems, such as triggering anti-dilution provisions and potentially other mechanics within the relevant constitutional and contractual arrangements.

To avoid this outcome, some start-ups have looked for alternative financing solutions, including raising money through the issue of convertible loan notes (thus deferring the question of valuation) or through exploring venture debt.

In some jurisdictions, governments have stepped in to invest in minority stakes in promising early-stage companies that may struggle to stay afloat. The UK's *Future Fund* and Germany's *Corona Matching Facility*, are two examples.

Such schemes could in some circumstances be a life saver. But the terms of that support and the impact it will have on other investors, not least the changing in stakeholder dynamics a government shareholder creates, call for careful consideration.

> "Valuing high-growth businesses is tricky in any environment and the pandemic has only made that process harder."



Is this the right time to invest?

Valuing high-growth businesses is tricky in any environment and the pandemic has only made that process harder. That is particularly true of early-stage companies where there are fewer financial metrics to assess the medium- and long-term growth potential of the business at a time of pending recession, the depth of which is still too early to predict.

Potential acquirers are bound to ask themselves whether it makes sense to invest at this most uncertain of times. On balance, the reasons for doing so can be compelling.

Covid-19 and the lockdowns imposed by governments across the world have accelerated consumer adoption of online financial services, leading to a rapid expansion of e-commerce and online banking, as people shift away from paying by cash at physical retail locations.

This steep rise seems unlikely to be reversed, even once lockdown measures are eased globally. Consumers and businesses increasingly expect to interact in a wholly digital environment and financial services is no exception. Increased use of digital technology is also driving demand for more sophisticated tools to manage and compare their accounts and financial products online. The UK's trailblazing work in establishing the country's open banking implementation framework has already driven substantial innovation and investment in data aggregation platforms and infrastructure.

Traditional banks – even those with well-developed digital strategies – still have much work to do to identify and adopt tech solutions that will allow them to meet the threat posed by online challenger banks and other disruptors. Their need to invest in fintech solutions has not gone away.

Regulators have generally been encouraging of innovation (with many establishing fintech 'hubs' to support product testing and development) and have allowed firms to grow with minimal supervision. However, as the market has matured – and some firms have taken up notable market share – regulators are applying increasing pressure on compliance with capital, consumer protection and financial crime rules. The well-publicised failure of players like Wirecard and Ipagoo may give investors pause.

In addition, with a recession looming, renewed pressure on the profits of some traditional banks is likely to force them to look for new cost savings and inevitably accelerate the adoption of tech solutions and innovation-led transformation.

There will be many potential targets. Fintechs, for all their short-term cash preservation challenges, may be well positioned to see out the downturn. They tend to be very lean organisations, free of the sort of supply chain disruption problems that can affect bigger operators.

There are also digital-first businesses often with market-leading abilities to harness and exploit data and entirely comfortable with doing so while working remotely. In other words, the case for investing in fintechs remains a strategic priority.

In the end, it is more about how, rather than if, deals will be executed, and the strategies investors need to adopt in this changed world.

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So who will be buying and how?

Given the uncertain market, traditional investors have held off high-value strategic deals in the short term.

There may, however, be scope for some opportunistic moves by investors looking to take advantage of the collapse in valuations.

Some investors, including financial institutions and funds, may well look to do distressed M&A deals as the market shakes out.

Moreover, just because most investors are shying away from big-ticket transactions right now does not mean they are inactive.

Cash-rich funds, for instance, are certainly assessing potential future acquisitions so that they can move in quickly on chosen targets when the outlook becomes clearer and valuations settle.

Private equity funds, for example, have already been active in the payments market, but the crisis could present opportunities for them to reach wider and deeper into the fintech sector. In particular, it may open the way for modular or buy-and-build opportunities, perhaps bringing a retail banking operation together with a cross-border payments business to create a viable challenger banking operation.

Mature fintechs could re-enter the market, provided that they have the funds. Some have already signalled their willingness to do deals, including Santander (which has recently launched a new fintech capital fund – Mouro Capital) as well as the online banking group, Revolut.

In recent months, Facebook has also continued to be active in that part of the market where payment systems and e-commerce intersect, launching services in various markets.

It has been adopting a collaboration strategy, willing to invest in or team up with potential competitors to test new markets and new regulatory regimes. Alongside PayPal, for instance, it joined the latest funding round for Gojek in Indonesia, securing a small stake in GoPay.

We are likely to see strategic collaborations and minority investing of this kind proliferate over the coming months, particularly where it allows investors to gain exposure to new technologies and markets on a 'try-before-you-buy' basis, with the potential to make a more substantial investment later.

Other areas of fintech that look ripe for heightened activity include:

- insurtech;
- digital ID and anti-fraud technology (particularly in light of recent EU calls for a pan-European ID scheme to aid know your customer efforts);
- online lending;
- wealth management; and
- electronic record keeping, including broader applications of distributed ledger technology.

Responding to increased demand for digital banking services will remain a challenge and a priority for traditional banks.

For banks, as for other investors, a key focus is likely to remain on minority investment in promising technologies and the teams behind them.

We also expect to see an increase in collaboration and strategic alliances as an alternative to out-and-out M&A transactions, at least in the immediate aftermath of the pandemic. The urgency of delivering on a digital strategy could force the pace of this activity.

For their part, the legacy institutions bring a number of enticing benefits to an aspiring fintech, not least a wealth of capital, a more developed and well-resourced regulatory and compliance infrastructure and an often very loyal customer base. It is easy to see why a collaboration will often be a tempting prospect for a tech company.

Pitfalls ahead

Even before the current crisis, traditional players looking to invest in fintech were on a steep learning curve. Many of the factors that add up to a successful investment strategy still apply, but the importance of some have been amplified by the crisis.

Issues that investors need to consider include:

– **Cultural difference** – The culture of a start-up or high-growth company is very different to that of an established big business – leaner, faster moving and less bureaucratic. Bringing those two cultures together successfully requires careful management.

– **Integration first** – Integration needs to be front of mind from the outset, before detailed due diligence gets underway. This is a model followed by many of the most successful tech companies when they go out to acquire new technologies or new talent.

– **Compliance** – Compliance processes and procedures in established companies will invariably be more sophisticated and more extensive than in a start-up. We have seen a number of potential deals come close to foundering because the start-up simply did not have the ability to invest heavily enough in compliance systems. Though such issues can be assessed by well-drafted warranties, it may not be possible to obtain sufficient comfort and they can prove decisive in whether a deal proceeds or not. Moreover, as financial institutions increasingly invest in early stage fintechs, the enhanced scrutiny to which fintechs are now subject will bring regulatory considerations to the fore. Where investors have a U.S. presence, regulatory (including financial crime) issues will be front of mind.

– **Walk-away rights** – Minority investment deals often include a right for the investor to abandon its investment, particularly in the financial services sector, allowing the investor to put its entire investment on the company for a nominal sum if and when such problems emerge. With a full-blown acquisition it is, of course, much harder to walk away.

– **Keeping teams on board** – The real value of a start-up often lies as much in the people behind the business as in the innovation they have developed. Making sure they are properly vested in the combined operation through effective management incentivisation is vital, whether that takes the form of shares, options or other package of remuneration. Nevertheless, things can go wrong, at which point ensuring the company and investors are sufficiently protected through appropriately negotiated non-competes and management equity vesting provisions becomes key.

– **New issues in a buyer's market** – With the balance of power swinging from seller to buyer, fintechs seeking funding or an exit will find themselves in a new and much trickier environment. Expect more conditionality in deal terms with warranty protections and repetition of warranties likely to feature more widely to ensure the buyer is properly protected. In addition, investors will continue to demand preferred status on liquidation events to secure the value of their initial investments and, where possible, guarantee a return (whether through an M&A exit or administration of the target), and anti-dilution provisions will continue to be a staple of minority investment deal terms.

– **Cyber risks** – For any online, data-rich business, falling victim to a 'hack' continues to be a material risk factor. With that comes operational challenges for fintechs seeking to integrate or provide products to established financial institutions, whose data security protocols have become increasingly

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costly and onerous for early-stage businesses to comply with. Equally, cyber risks do not go unnoticed by investors now that fines under GDPR can materially alter the economics of a deal, bringing with it increased focus on data protection due diligence together with robust cyber/data warranties and indemnities where appropriate.

– **Greater antitrust scrutiny** – Regulatory oversight of tech companies is increasing rapidly as the pressure mounts on the authorities to ensure that antitrust rules are fit for an increasingly digital and globalised world. This is a debate that has increased in light of the speed of recent digital transformation during the Covid-19 epidemic. In June 2020, the European Commission unveiled its plan for potential action to address these concerns, the most radical part of which is the proposed ex ante regulation of digital platforms.

  The potential market dominance of the very biggest tech companies, and their ability to stifle competition by snapping up small businesses that might one day be challengers (so-called 'killer acquisitions') is coming under increasing scrutiny from the regulators. In the payments segment, the spotlight is on Apple Pay and Google Pay, with the European Commission (Apple Pay) and Indian authorities (Google Pay) looking respectively at their activities.

– **Greater state involvement** – The crisis has led to greater state intervention than we have seen for many decades across sectors and jurisdictions. This is particularly evident in the area of foreign direct investment, where tougher controls are being imposed on the grounds of national security or public interest. While most fintech companies would be unlikely to be seen as systemic in the same way that major too-big-to-fail banks are, this could begin to change as the industry matures and as challenger banks grow. State investment in struggling fintechs, as described above, could also be a double-edged sword. Short-term security could come at the cost of longer-term complexities around ownership and political interference.

The road ahead

The fintech sector enjoyed a period of extraordinary growth following the financial crisis.

While the pandemic has certainly brought that period of unbroken development to a halt, we believe that we are experiencing a hiatus in fintech investing rather than an existential challenge to this still buoyant sector.

Growth may take some time to return to pre-pandemic levels. But an eventual resurgence does look probable, even if the pattern of investment changes in the short term and investment committees remain cautious for a few months more.

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Beyond Covid-19: Conduct risk and the regulatory reckoning awaiting the UK's financial institutions

The economic impact of the Covid-19 crisis is resonating across the UK's financial institutions and their employees. It has already resulted in dramatic changes to the financial risk profiles of banks and other financial institutions.

In the aftermath of the pandemic, boards and senior managers will be held accountable for failures and regulatory breaches, and Senior Managers and Certification Regime (SMCR) requirements will be enforced notwithstanding the working environment being virtual. Firms and senior leaders need to ensure that the decisions, judgments and actions they take through this crisis can withstand close scrutiny in the years to come.

The lessons that emerged from the global financial crisis of 2008 provide a practical insight into the challenges that lie ahead. In its wake, UK regulators reviewed the decisions of firms and senior leadership during the crisis, ordered detailed remediation programmes in relation to regulatory failures and levied record fines in relation to the worst conduct such as rogue traders, market manipulation and market abuse. The total bill for the financial sector globally from regulatory findings after the event ran to billions of dollars and the SMCR rose from the ashes.

The legacy of misconduct following the last crisis means that, in the current crisis, regulators' focus is firmly on conduct. In our view, three areas of conduct risk are likely to come under particular scrutiny from regulators as to how financial services firms handle the difficult and conflicting pressures generated by the Covid-19 crisis:

– market conduct risks;

– retail conduct risks; and

– conduct issues in relation to small and medium-sized enterprise (SME) lending decisions.

"The lessons that emerged from the global financial crisis of 2008 provide a practical insight into the challenges that lie ahead."

Market conduct risks

Banks need to be vigilant for the heightened risks of market abuse and must ensure that the expectations of the company in relation to culture and conduct are clearly and frequently communicated. Management information and frequency of reporting must be adapted for the Covid-19 environment and the market abuse risk assessment should be updated to consider increased risks, such as risk of misleading statements by corporates and insider dealing.

Ironically, the relaxation of corporate reporting timelines designed to ease the supervisory burden on firms may have heightened the risk of insider dealing as material non-public information (MNPI) has to be protected for much longer periods. Front office controls, monitoring and surveillance of conduct may need to be adjusted to take account of market conditions and changes in working practices.

The crisis has undoubtedly increased the pressure on some firms and individuals to perform financially and this can create an incentive towards misconduct. In parallel, the remote working arrangements that firms have put in place can make misconduct more difficult to identify and control.

Banks, for example, have faced challenges meeting minimum requirements in relation to recording voice communications and relating to the lack of physical oversight of e-communications channels such as social media. There has been a huge spike in the use of the encrypted messaging app WhatsApp as thousands of finance workers have been relying on personal devices more in their home-working setups. Some of the biggest global banks are testing technology that would allow them to record and monitor employees' WhatsApp messages.[1] Firms are also using trading limit controls, more frequent supervisor check-ins and daily attestations to bridge the controls gap created by the lack of physical oversight.

Retail conduct risks

On the retail side, the customer treatment approach needs to be reassessed for the Covid-19 environment, taking into account regulatory encouragement towards forbearance, but balancing this with existing contractual obligations and the possible longer-term adverse impacts of the crisis on a customer's financial position.

The position of vulnerable customers is also likely to remain a priority of the Financial Conduct Authority (FCA) in the context of Covid-19. Communication with customers is essential, and senior managers must be fully informed as to how frontline staff have been trained in revised customer treatment policies.

Management information should include data monitoring as to whether customer treatment policies including customer complaints information are being applied correctly. All actions and decisions should be thoroughly documented, in a manner that demonstrates the reasoning and not just the outcomes of the decision-making process. Clear records will be critical in the aftermath.

1. *Bankers beware: Financial giants to monitor staff WhatsApp messages*, Financial News, 18 May 2020.

Conduct issues in relation to SME lending decisions

The FCA's "Dear CEO" letter concerning banks' lending to SMEs encouraged banks to pass through to businesses and consumers, as soon as possible by way of loans, the benefit of the measures such as The Coronavirus Business Interruption Loan Scheme (CBILS) announced by the government. SMEs can borrow up to GBP5 million under CBILS with the government guaranteeing 80% on each loan and covering the first 12 months of interest payments. The Scheme has now been extended to 30 November 2020.

In practice, banks are being encouraged by the FCA and indeed the Treasury and MPs to adopt a higher credit risk tolerance than they would have adopted before the pandemic in order to support SMEs. While the activity of business lending to SMEs is not directly regulated in the UK, the SMCR will apply to senior managers in banks, and each bank should have at least one senior manager with clear responsibility for the activity of lending to SMEs and fair treatment in relation to them.[3]

When considering an application under the CBILS scheme, banks are therefore in a difficult position. They must take a view as to how the loan will be repaid, relying on judgment as to credit risk in the absence of reliable financial forecast information. If they do lend to companies that subsequently cannot afford the repayments and are forced into liquidation as a result of the banks pursuing them before claiming under any guarantee, then the lending departments of these banks may come in for regulatory criticism on the basis that they failed to apply prudent lending and affordability requirements.

On the other hand, if they do not lend, businesses that do collapse during the pandemic might turn to the courts to blame banks for failing to lend through the government loan scheme that was expressly designed to keep them afloat.

Banks can only act reasonably on the information they have available about credit risk, in the knowledge that their judgment will be under scrutiny in the aftermath of the crisis. However, banks need to consider carefully how their lending schemes under CBILS are administered, and what conduct risk frameworks are in place to minimise the risk that subsequent inquiries into banks' decisions conclude that banks acted unreasonably. Moreover, banks' lending decisions must be fair as between different cohorts, with differences in outcomes objectively justifiable and reasoned – and recorded in writing.

There is no doubt that in the aftermath of the crisis, the FCA will follow up with enforcement action where there is evidence of firm-wide or sector-wide failures to act reasonably, fairly and consistently in relation to SME lending.

The road ahead

Senior-level decision-making and oversight during the Covid-19 crisis are undoubtedly challenging and complex. However, if firms do not navigate the challenges in these conduct risk areas to maximise the chances of fair and reasonable outcomes for their stakeholders, then there is likely to be a serious regulatory reckoning when the dust settles.

2. The FCA will take into account the Lending Standards Board's ("LSB") Standards of Lending Practice for business customers (as amended for Covid-19) when considering how senior managers and other bank employees discharge their duties in relation to SME lending, and bank CEOs and boards must take reasonable steps to ensure that the designated SME-lending senior manager is discharging their duties suitably and effectively. LSB has made a statement to the effect that it would consider participating firms' compliance with the requirements of the government's schemes to be in compliance with the relevant provisions of the Standards of Lending Practice.

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Beyond Covid-19: How will the shifting balances of power in the commercial real estate sector in England and Wales affect financial institutions?

As the economic ramifications of Covid-19 are felt across society, it is clear that the implications for financial institutions as lenders and investors in commercial real estate are significant.

There has been considerable Government intervention to assist tenants, particularly in the retail and hospitality sectors, but as yet little by way of support for landlords. Will this result in a shifting balance of power between investors in and financiers of commercial real estate assets and their tenants? What are the implications for financial institutions?

To pay or not to pay?

Rental income flows are fundamental to most real estate asset class investments and yet, during the Covid pandemic, rent recovery rates have been greatly reduced. According to data from Re-leased

> "For the retail sector in particular, Covid-19 has in some ways exacerbated pre-existing structural weaknesses."

(a commercial property management platform which collated data from 35,000 leases), commercial landlords received 22.1% of the rents due on the 29 September 2020 quarter day, up slightly from 18.2% on the June quarter day but down from 25.3% on the March quarter day. The British Property Federation has estimated that the total unpaid rent in the UK commercial property market between late March and the end of December will be around GBP4.5bn. Yet, without specific government intervention most tenants will not have a right under their leases to withhold rent, have their rent suspended or reduced or alter the way in which their rent is paid as a result of the Covid-19 pandemic. Indeed, most leases expressly prohibit the withholding of rent in any circumstances and, while rent suspension clauses are common, they are usually limited to situations where there has been damage or destruction to the property. UK Government intervention has, however, increasingly removed the ability of landlords to pursue the non-payment of rent, and this has arguably shifted the balance of power in favour of tenants at least in the short term.

The key remedy in the event of failure by a tenant to pay rent is the forfeiture of the lease. However, a moratorium on the ability of landlords to exercise any rights of forfeiture (or continue with any existing forfeiture proceedings) for non-payment of rent (including service charge and insurance premiums) was introduced in March. Initially, this was to apply until 30 June 2020 but it was subsequently extended until 30th September 2020 and then recently extended further until 31 December 2020. While it has been a cause of concern for both investors and financiers active in the real estate sector, it is important to note that the moratorium does not amount to a rent holiday. Landlords are still owed the rent (usually together with interest) and will be able to bring forfeiture proceedings at the end of the moratorium where the rent and other sums have not then been paid. The moratorium also does not prevent landlords from forfeiting where a tenant breach does not relate to non-payment of rent. Furthermore, in the current climate, forfeiture may not be a landlord's preferred course of action in any event, due to concerns over the ability to re-let in the near future.

Further restrictions on the ability of landlords to pursue tenants for the payment of rent have also been introduced. The Corporate Insolvency and Governance Act 2020 temporarily removes the threat of statutory demands and winding-up proceedings where any unpaid debt is the result of Covid-19. Statutory demands will be void if issued against a company between 1 March 2020 and 31 December 2020. During this period, winding-up petitions presented claiming a company is unable to pay its debts will be reviewed by the court to determine the cause of non-payment. If this is because of Covid-19, no winding-up order will be made. The Government has also introduced legislation to provide tenants with more breathing space to pay rent by preventing landlords from using Commercial Rent Arrears Recovery (CRAR) unless they are owed at least (a) 90 days' unpaid rent where the notice of enforcement is given on or before 30 June 2020, (b) 189 days' unpaid rent where the notice is given on or before 30 September 2020, (c) 276 days' unpaid rent where the notice is given on or before 24 December 2020 and (d) 366 days' unpaid rent where the notice is given on or after 25 December 2020. As a result of these Government interventions, the hands of landlords are increasingly tied when it comes to demanding rent and this has resulted in an immediate, if temporary, shift in the balance of negotiating power.

Consequently, many tenants (particularly in the retail and hospitality space) have demanded rent and service charge concessions, even in some cases where they could afford to pay rent. Many landlords have been accommodating legitimate requests by tenants to pay rent monthly rather than quarterly in advance in order to preserve cash flows, as well as allowing some tenants rent-free periods (ie rent holidays) of up to three months and/or rent deferrals (ie where the rent is deferred for a specified period but will ultimately still be paid). A number of retailers are also pushing for turnover linked leases in an attempt to share the risk. In some cases, however, requests to share the burden are turning into opportunities for tenants to completely restructure leases. CVAs and pre-pack administrations are being used or threatened in an attempt to reset more onerous leases. Landlords face unenviable commercial decisions as to how best to proceed. While it may arguably be in their best long-term interest to help keep key retail tenants solvent, agreeing to rent suspensions may cause substantial issues particularly where tenants were already liable to fail before the advent of Covid-19. In these circumstances, landlords may prefer to regain possession of their properties. Landlords may also have financing payment obligations of their own or be reliant on lease cash flows to meet payment obligations under complex financial structures. Alternatively, they may be operating investment funds with the expectation of returns to investors. Parties will need to actively manage their portfolios to try to optimise the outcome.

A new Code of Practice

On the 19th of June 2020, the UK Government published a new voluntary Code of Practice for commercial landlords and tenants which encourages transparency and collaboration. Critically, it confirms the legal position that tenants will remain liable for rent arrears and encourages tenants to pay as much rent as possible (noting that where tenants have received funds or savings from Government support schemes, these should be put towards liabilities including rent). Equally, landlords are expected to show leniency where they can afford it, taking into account their own financial arrangements. The Covid-19 legislation does not suspend obligations owed by landlords to their lenders. How much effect this voluntary Code is having in practice remains to be seen. However, it is worth noting that although the September 2020 rent recovery rates remain low, according to Re-leased in all sectors other than retail there was an improvement in comparison with the previous quarter. This may be testament to the ongoing efforts by landlords and agents to maintain occupier relationships during a volatile period. Indeed, given the ongoing landlord/tenant negotiations which have been taking place since March, the stated recovery rates may not be reflective of the true position. Given that many tenants have moved to a monthly payment schedule, two-thirds of the rent for the September quarter may not yet be due. In other cases, the headline rent may already have been reduced by agreement. The true position may therefore take some time to emerge.

What does this mean for financial institutions in the future?

The days of institutional investor landlords having an arsenal of weapons to employ against a defaulting tenant in order to maintain income stream are currently therefore gone, at least in the short term. However, once the immediate Covid-19 crisis has passed, financial institutions active in the real estate market will be re-evaluating their positions and their relationships with tenants and borrowers alike. Litigation claims are likely to follow where a consensual option has not been pursued (or appropriately documented) and parties would do well to keep that in mind.

For the retail sector in particular, Covid-19 has in some ways exacerbated pre-existing structural weaknesses; future challenges were already being discussed by the larger retail landlord investors and funds well before any form of pandemic was envisaged. By contrast, logistics and industrial warehousing could become net beneficiaries of the Covid-19 fall out, while demand for office space may be reduced as working from home becomes more culturally normalised. Risk sharing provisions relating to future pandemics may become more common with parties agreeing contractually to share the risks associated with future lockdowns, in a similar way to other uninsured risks.

Financial institutions will find a real estate market much altered by Covid-19. However, falling asset values will create significant opportunities for well-funded players and proactive asset management will become increasingly fundamental to success. Any compromise position should also be formally documented to mitigate the risk of subsequent disputes. Given the symbiotic nature of the relationships between financial institution investors and lenders and occupational tenants, financial institutions will need to tread carefully, balancing the commercial imperatives and their own risk appetite against the constantly shifting balance of power caused by Covid-19.

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Will climate change go up the boardroom agenda following Covid-19?

We believe that the global Covid-19 pandemic will lead to society at large taking climate change much more seriously. While parts of the business and financial community, and governments and regulators have taken action, there remain pockets of disbelievers who question whether this fits squarely into a business imperative.

However, the emerging post-pandemic world has demonstrated a number of things, one being how quickly public opinion can shift from sceptical interest to intense concentration, and in some cases fear. So if the unthinkable pandemic has occurred, why not climate change, with consequences arising from some scenarios which could make Covid-19 and a global recession look like a walk in the park?

Another clear consequence is the need for government primed responses to recession and job losses. Vast amounts of money have been pumped into trying to preserve jobs, with more to come, and on rebuilding certain devastated industrial sectors, such as hospitality and travel – and what better than infrastructure projects? The pressure to rebuild using a 'green' agenda may become overwhelming. Looking up at the empty skies, and on the empty roads, environmental benefits have been there to see and touch for everyone, so why go back?

So we conclude that there may be a step change in relation to climate change initiatives. But what could this look like, and what does it mean for business?

> "More legislation and change is coming, and forward-looking organisations will try to get ahead of these changes."
>
> Chambers 2020

Where are we now?

The direction of travel has been clear for some time, with the Paris Agreement and other United Nation's sponsored initiatives, being embraced at government levels. The next big push in this area was to be COP26, scheduled for July 2020 in Glasgow, but has been postponed to next year. Nevertheless, the momentum remains. This has drilled down into sector-based initiatives, such as the Task Force on Climate-related Financial Disclosures (TCFD), set up by the Financial Stability Board, chaired at the time by Mark Carney, then Governor of the Bank of England. Carney has since become the UN Special Envoy for Climate Action and Finance, and is proving to be a powerful advocate. He speaks to businesses and the financial services sector with a credible business background, and not as a scientist/expert, and is all the more persuasive for that.

The current emphasis is largely voluntary. It is often driven by disclosure, trying to force change through momentum, rather than legal or regulatory standards. But the direction of travel here is, in our view, also clear: more legislation and regulation are coming, and forward-looking organisations will try to get ahead of these changes, and shape what is coming.

We are also seeing this on the so-called 'buyside', the investor community. The world's largest asset manager, Blackrock, has said that it will take a 'harsh view' of companies that fail to provide hard data on the risks they face from climate change. Those that do not engage with the climate agenda, and what is required and heading in their direction in terms of planning, disclosure and reporting, are likely to face greater scrutiny from investors who may start to see corporates in a bifurcated manner, between those 'sinners' and 'saints', or 'green' and 'brown'.

So the question for business now is how they position themselves in that debate. Much of this will be driven by the growth of 'green' funds looking for equities that tick the box.

But there are practical legal and commercial issues that should also be considered. And the legal industry is not standing idly by. Some legal commentators are already calling climate change litigation the 21st century equivalent of tobacco litigation; we somehow doubt it, but lawyers are

ingenuous people and adept at making law through trials and cases, and so it remains to be seen. But climate litigation is a real risk and needs to be assessed and mitigated.

Climate litigation comes in a variety of forms, some of which might be comparable to the cases against tobacco companies. We think the biggest concern may be mis-selling claims. Funds are looking for green investments to satisfy investment criteria, but are not properly looking under the bonnet to work out whether an equity holding in company X really is 'green'. It is very fuzzy at the moment, as there is a lack of clear and consistent definition of what is 'green'.

While it is unlikely that there will be the sort of products liability claims that there were for tobacco, there have been some tort law and statutory claims already including in The Netherlands, France and Germany (see Exhibit 1 for examples of climate change litigation). These sort of claims may not pose a realistic chance of success under the common law in the UK law and there is no statute on which to base them. However, we are seeing claims that are being brought against businesses by municipalities and states in the U.S. to recoup the costs of damage associated with climate change.

Similar claims were brought against tobacco companies, which were generally settled. To date, some of these climate-related cases have been dismissed by judges in the U.S. who have said that the issue is for Congress to handle, but others are pending. And finally cases are also being brought for fraud. The New York attorney general recently lost such a case against a global oil and gas company, in which it was alleged that the company understood the science of global warming, predicted its catastrophic consequences, and then spent millions to promote misinformation.

"Those that do not engage with the climate agenda, and what is required and heading in their direction in terms of planning and reporting, are likely to face great scrutiny."

Chambers 2020

What does this mean?

For businesses generally, we can predict a continuation/acceleration of existing themes:

- For those that are listed and/or regulated, more disclosure/reporting and the governance structures and conduct issues which go with it.
- More chance of litigation, so start planning now for defence and mitigation strategies.
- Anticipating change, and getting ahead of it. For example, many companies have published their plans to go carbon zero, do that and report/audit the plan.
- Look at your competitors. Are you 'green' or 'brown' when judged against them?
- If you are a retailer or consumer business, how do you look and engage with your customer and consumer base? Could you withstand a public campaign against you?
- How do other stakeholders: investors, regulators, suppliers, employees view your green credentials? Do you walk the walk, as well as talk the talk?
- Put it on your risk register now.
- Get scientists and other experts into your boardroom now, when you have time, so board awareness grows.
- Who owns this? The chair, the board or the CEO? How does it impact your brand and marketing?

Lenders and investors will apply a new set of lenses in their spectacles when they look at you, with a special climate/environmental lens, sitting closely alongside the ESG lens:

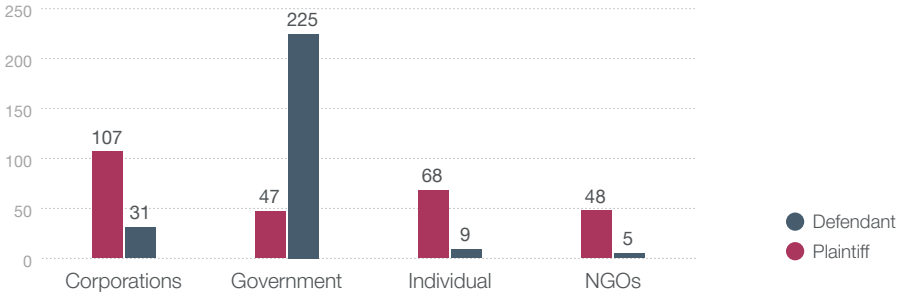
- If your assets are potentially climate affected, do you carry them at a true value in your books (for example, a power station based on a coast line, to access sea water for cooling)?
- Greater due diligence to establish how climate affected your business is, looking at regulatory/litigation exposures, sustainability, supply chains, customer reaction and brand, asset values etc.
- Are you 'greener'/'browner' than your peer group?
- Certain industries may find themselves largely unbankable, for example, coal mines, so the cost of credit rises, affecting their business model, and the same may apply to equity markets. So where do they go for capital and at what cost? Or do they die, either overnight, or slowly by a thousand cuts?
- Conversely, the pressure to invest in 'green' businesses may enhance access to debt/equity markets.
- Pressure on lenders'/investors' boards and executive committees to fund more 'green' businesses, and to divest from 'brown' industries.

To identify just a few consequences.

"Getting ahead of legal and regulatory change makes good business sense."

The number of climate-related law suits by category of party

Number of plaintiffs and defendants in litigation dataset by type



Source: Climate Change Laws of the World database, Grantham Research Institute on Climate Change and the Environment and Sabin Center for Climate Change Law

Examples of climate change litigation
1. Protection/loss and damage – cases brought by municipalities and states for public nuisance, including from climate change – compensation for damage and future impacts
2. Public interest litigation against governments – litigation calling for new laws and policies – spurring government action
3. Information/disclosure litigation – claimants demanding disclosure or action plans – claims for misleading or incomplete disclosure – claims for "greenwashing" marketing campaigns
4. Administrative cases – challenges to decisions on basis of environmental factors – failures to conduct EIAs
5. Tort actions against corporates – individual or mass tort claims often based on negligence or nuisance – expanding parent company liability for subsidiaries, supplier and lender liability might be next – new tort actions created by national due diligence regimes – compensation for damages

Getting ahead of legal and regulatory change

Like everything in business, it is best to plan for the worst, while hoping for the best. Getting ahead of legal and regulatory change makes good business sense, and also keeping an eye on the rear view mirror, and what the competitive landscape looks like. Once labelled 'brown' or a 'sinner', it's likely to be hard to restore brand value. This requires expert advice, whether scientific, regulatory, governance or legal-review and now!

As businesses look to emerge stronger and more resilient in the wake of the Covid-19 crisis, now is the time for risk, compliance and legal professionals to take stock, learn and apply lessons, and ensure their functions are supporting company-wide efforts to be in better shape for next time.

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Floods, fires and financial markets – the emerging lexicon of climate change risks

On 9 September 2020, the Commodity Futures Trading Commission's (**CFTC**) Climate-Related Market Risk Subcommittee of the Market Risk Advisory Committee (**MRAC**) released a report entitled 'Managing Climate Risk in the U.S. Financial System'.

The report presents 53 recommendations to mitigate the risks to financial markets posed by climate change. In reaching those recommendations, the report issues a series of fundamental conclusions about the impact of climate change on economic and financial markets and the increasing likelihood of severe and unpredictable change.

In particular, the MRAC confirmed that: (i) climate change poses a major risk to the stability of the U.S. financial system and to its ability to sustain the American economy; (ii) climate risks may also exacerbate financial system vulnerability that have little to do with climate change; including vulnerabilities caused by a pandemic that has stressed balance sheets, strained government budgets and depleted household wealth; and (iii) U.S. financial regulators must recognise that climate change poses serious emerging risks to the U.S. financial system, and they should move urgently and decisively to measure, understand and address these risks.

Notably, the report observed that "regulators should also be concerned about the risk of climate-related 'sub-systemic' shocks", which are events "that affect financial markets or institutions in a particular sector, asset class, or region of the country, but without threatening the stability of the financial system as a whole".

This acceleration of climate-related risk exposure comes against the backdrop of growing demand from investors, shareholders, consumers, and some governments for more – and more detailed – public disclosure. This growing demand is being driven by a broad range of inter-related factors, including among others:

– a solidifying (and perhaps nearly solidified) international consensus that climate change is real;

– increased recognition that climate change and other environmental, social and governance (**ESG**) costs and risks can materially impact business earnings and prospects;

– an evolving global consensus that **ESG** costs and risks (including but not limited to climate and carbon) should be accounted for and disclosed both to investors and to the public more widely; and

– increasing shareholder activism focused on climate and ESG.

If there were any doubt about the direction these issues are taking, it should be erased by Blackstone CEO Larry Fink's January 2020 annual CEO letter,[1] in which Fink argued that climate and sustainability must be corporate – and financial investment – priorities. Asserting that "[c]limate change has become the defining factor in companies' long-term prospects", Fink announced that Blackrock would take a number of steps to make "sustainability… our new standard for investing".

Among other things, Fink pledged to: (i) make "sustainable funds" the standard building blocks of its investment strategies; (ii) ensure that every Blackrock investment team integrates ESG reviews in its investment processes; (iii) reduce ESG risk in its active investments by substantially reducing coal investments; (iv) focus investment on solutions that support the transition to a low-carbon economy; and (v) develop and promote metrics to measure and compare companies' climate/ESG risk profiles, which will be fundamental to all investors' ability to accurately price risk and assets around the world.

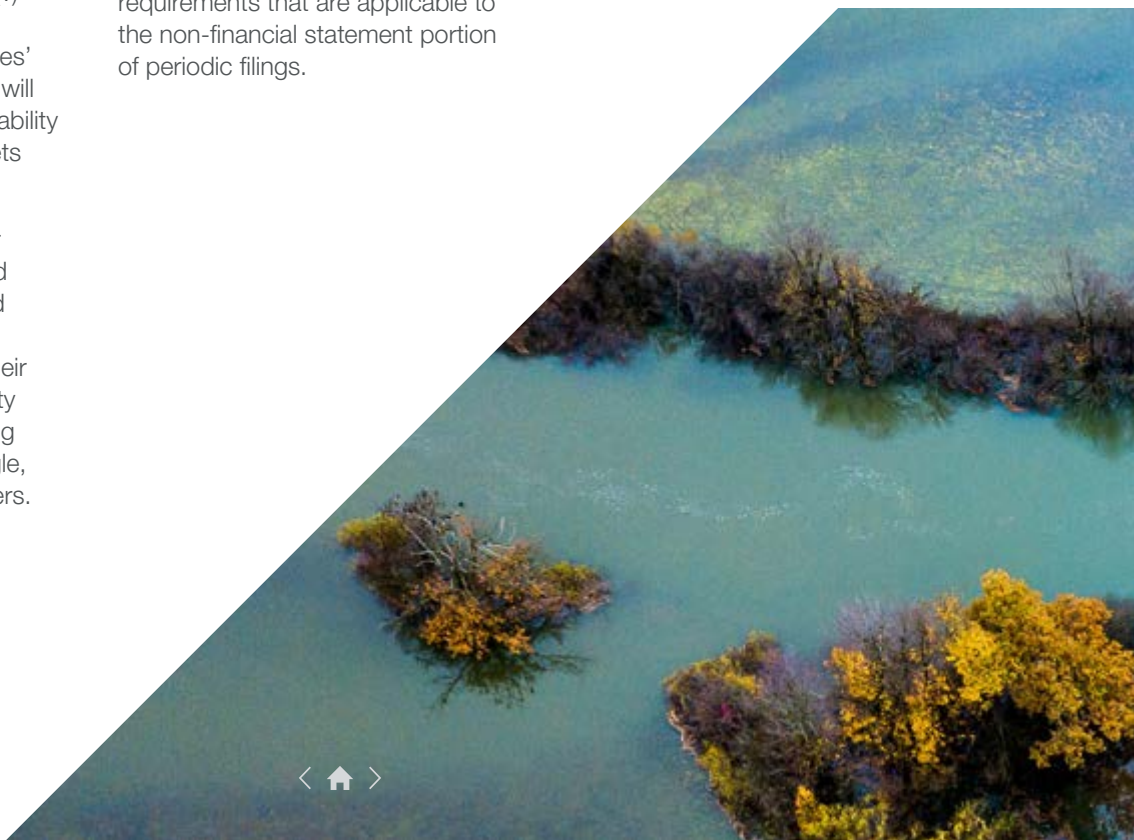
Following Blackstone's lead – or mirroring his approach – a broad range of global corporations and financial institutions have made similar announcements about their own commitment to sustainability and addressing climate, including Microsoft, Amazon, Delta, Google, Goldman Sachs, and many others.

While market and investor demands appear to be playing the driving role in influencing ESG behaviour, governments may be beginning to catch up. As part of the European Commission's "European Green Deal", in January 2020 the Commission launched a preliminary consultation on alternative approaches for revising the Non-Financial Reporting Directive (Directive 2014/95/EU) (**NFRD**).[2]

Active discussions are ongoing, and, while they are very preliminary, it is widely expected that some new reporting requirements will be implemented. Such new requirements are likely to have a ripple effect in other parts of the world, including the United States.

U.S. disclosure guidance on climate is governed principally by Regulation S-K and limited guidance issued by the U.S. Securities and Exchange Commission (**SEC**) in 2010 (the **2010 Climate Disclosure Guidance**)[3]. SEC rules generally require public companies to disclose, among other things, known trends, events and uncertainties that are reasonably likely to have material effect on the company's financial condition or operating performance through annual or other periodic filings. Regulation S-K contains disclosure requirements that are applicable to the non-financial statement portion of periodic filings.

"This acceleration of climate-related risk exposure comes against the backdrop of growing demand from investors, shareholders, consumers, and some governments for more – and more detailed – public disclosure."



The SEC published the 2010 Climate Disclosure Guidance to provide guidance to companies on how existing requirements apply for climate-related matters.

The 2010 Climate Disclosure Guidance identifies four items in Regulation S-K that might require climate-related disclosure in periodic filings:

– **Description of business** – Item 101 of Regulation S-K requires a registrant to describe its business and that of its subsidiaries. In particular, a registrant ordinarily must disclose any material effects that environmental matters may have on the financial condition of the registrant.
The registrant is required to disclose two particular pieces of information regarding environmental matters: (i) the material effect of complying with federal, state and local regulations concerning the environment; and (ii) any material estimated capital expenditures for environmental control facilities.

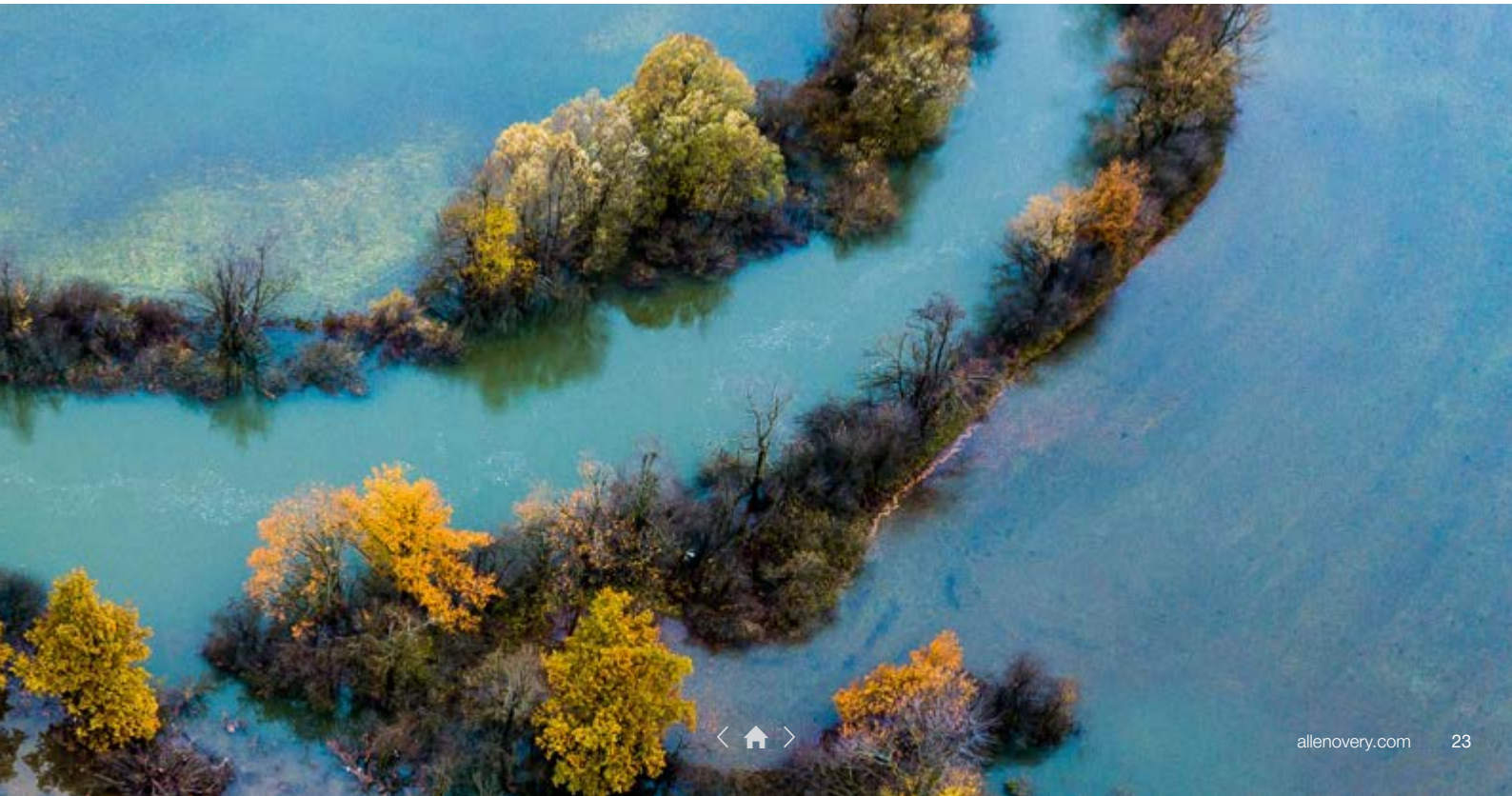
– **Legal proceedings** – Item 103 of Regulation S-K requires a registrant to briefly describe any material legal proceeding to which it or any of its subsidiaries is a party. This includes proceedings "known to be contemplated" by governmental authorities.

– **Risk factors** – Item 503(c) of Regulation S-K requires a registrant to provide where appropriate, under the heading "Risk Factors", a discussion of the most significant factors which make an investment in the registrant speculative or risky. Item 503(c) specifies that risk factor disclosure should clearly state the risk and specify how the particular risk affects the particular registrant.

– **Management's discussion and analysis** – Item 303 of Regulation S-K requires disclosure known as the Management's Discussion and Analysis of Financial Condition and Results of Operation, or MD&A. Item 303 includes a broad range of disclosure items that address the registrant's liquidity, capital resources and results of operations. Registrants, for example, must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance. This disclosure should highlight issues that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition.

The 2010 Guidance also identified four different topics under which climate-related risks can be categorised and for which disclosure may be required under the federal securities laws. Those topics are: (i) impact of legislation and regulation; (ii) international accords; (iii) indirect consequences of regulation or business trends; and (iv) physical impacts of climate change.

The SEC has not updated its 2010 Climate Disclosure Guidance, and the agency's most recent proposals in January 2020 to modernise Regulation S-K and Regulation S-X did not address climate-related risks. Similarly, revisions to the EU's NFRD will take some time to develop and come into force. Still, U.S. companies and financial institutions could face regulatory scrutiny on



climate-related matters from a number of regulatory agencies.

In late 2019, two senior U.S. Federal Reserve Board officials made notable public statements about potential climate change impacts on the U.S. economy. Kevin Stiroh, an executive vice president of the Federal Reserve Bank of New York, declared that "[t]he U.S. economy has experienced more than USD500 billion in direct losses over the last five years due to climate and weather-related events".[4]

He added: "Climate change has significant consequences for the U.S. economy and financial sector through slowing productivity growth, asset revaluations and sectoral reallocations of business activity."[5]

Stiroh reinforced these comments in March 2020, when he cautioned that "financial markets and institutions face the potential for a 'Minsky moment' related to change climate – an abrupt repricing of assets in response to a catastrophic event or change in investor perceptions".[6]

Stiroh's concerns were echoed by Federal Reserve Governor Lael Brainard, who said: "[to] the extent that climate change and the associated policy responses affect productivity and long-run economic growth, there may be implications for the long-run neutral level of the real interest rate, which is a key consideration in monetary policy".[7]

Brainard noted that based on climate-related financial exposures reported to the Carbon Disclosure Project, estimates are that "the 500 largest companies by market capitalization are exposed to nearly USD1 trillion in risk, half of which is expected to materialize in the next five years".[8]

Similarly, as part of its report, the MRAC recommended that The Financial Stability Oversight Council (**FSOC**), as part of its mandate to monitor and identify emerging threats to financial stability, should incorporate climate-related financial risks into its existing oversight function, including its annual reports and other reporting to Congress.

Under the current working framework, the regulators serving on the FSOC have established a list of roughly six criteria to be applied when evaluating whether a financial activity "could amplify potential risks to U.S. financial stability".

As the Federal Reserve and other U.S. financial market regulators begin to assess the risks of climate change, the larger question remains as to how those agencies will integrate those risks into their regulatory and supervisory frameworks. With investors paying increased attention to climate-related risks and as most firms lack detailed quantitative disclosures, it is critical that companies (including in particular but not only publicly-listed companies) develop internal processes for identifying climate and other ESG risks and assessing their potential impact on their financial condition.

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Is your contractual notice period enforceable in France?

International companies doing business in France are often baffled to find that their contractual notice periods are unenforceable. This is due to a specific regime that requires lengthy notice to be given before terminating a commercial relationship. A recent decision from the Paris Appeal Court, however, clarifies how to mitigate the risk of being stuck with an unwanted business partner.

Prohibition of abrupt termination: a French specific regime

Under French law, a party to an 'established' commercial relationship cannot terminate it without providing sufficient written notice to the other party; in other words, there can be no 'abrupt termination', irrespective of the contractual provisions. The rationale is to give the non-terminating party sufficient time to redirect its activities towards new customers.

Why do International companies need to pay attention to this French abrupt termination regime?

International companies need to pay attention to this French regime as:

- **The scope is very wide**: the Courts assess whether a relationship is established from an almost purely factual point of view, based on its length, stability and intensity. The regime applies irrespective of the parties' contractual framework, be it a long-term agreement or a succession of short-term orders. There are limited exceptions (including property lease agreements and contracts with commercial agents). Financial institutions should be aware of this regime as it will apply to the institutions' own relationships (although this regime does not apply to the termination or non-renewal of credit lines or loans) as well as representing potential liability for this institution's clients.
- **It is mandatory**: this regime cannot be excluded and supersedes any contractual arrangement, in particular prior notice clauses (if any). For instance, if your contract provides for a two month prior notice but your business partner is entitled to six months under the abrupt termination regime, the applicable notice would be six months and your contractual provision will be unenforceable.
- **It is not harmless**: French Courts typically require one month of notice for each year the relationship has been in place, sometimes longer depending on the non-terminating party's economic dependency on the relationship. Additionally, the Courts can take into account relationships entertained with the parties' predecessors, which can dramatically increase what they consider to be the sufficient notice period. French Courts sometimes impose up to 24 or 36 months. French law now stipulates an 18-month cap; however, how this applies is unclear and we cannot rule out that Courts may still impose longer notice periods in some cases. In any event, the French regime is more severe than other European legislations, for instance, German law usually imposes up to six months or, maximum 12 months.

What are the risks for international companies arising from the abrupt termination regime?

- **Lack of familiarity**: international companies are not always familiar with these French-specific rules, even when they have been doing business in France for a long time. The reasons for this lack of awareness include: it is counterintuitive to depart from the agreed contractual provisions; the length of the prior notice under the abrupt termination regime is not determinable at the outset but changes over time; and the abrupt termination regime is very French-specific. Indeed, their French business partners are often also unaware of this regime.
- **Court proceedings**: at A&O, we often see companies discovering the regime's existence after a contractual termination, which is then alleged to be an abrupt termination, at a point where they are dragged into lengthy proceedings before French Courts or arbitral tribunals. The claimant asks for damages or for an injunction forcing the terminating party to resume the relationship.

This happens regularly; French Courts settle about 300 abrupt termination claims per year. The relatively modest costs of litigation in France and the fact that the losing party often bears only a fraction of the winning party's costs incentivise non-terminating parties to try their luck and start proceedings.

– **Financial risk**: the resulting financial risk can represent millions of euros. Recoverable damages include the non-terminating party's loss of profits during the notice period it should have enjoyed (calculated on its net margin), as well as the specific investments it made in expectation that the relationship would continue.

– **Continuing an unwanted commercial relationship**: companies spontaneously complying with the abrupt termination regime or forced to comply with it by the Courts are not better placed. During the notice period, parties are to conduct business 'as usual', meaning sales volumes during the notice period should be substantially the same as before the notice was given. Partial termination involving a sharp decrease in volume rather than an actual termination is also prohibited. As a result, the terminating party might have to maintain a commercial relationship for a potentially long period, on terms which no longer reflect market conditions.

How to mitigate such risks?

Until recently, the application of the abrupt termination regime seemed almost inevitable, even for international commercial relationships. This was because several French appeal court decisions held that it was part of the French 'overriding mandatory provisions' (as defined by the Rome I Regulation); this means that French Courts would have to enforce it regardless of the law applicable to the commercial relationship provided the French market was affected. However, the French Supreme Court has never confirmed this position and case law is divided on this issue.

In June 2020, the Paris Appeal Court issued a decision that could end this debate. The Court decided that the abrupt termination regime is not part of the French overriding mandatory provisions because the regime protects private rather than public interests (as required by the overriding mandatory provisions).

Accordingly, parties doing business with a French company can exclude this regime by selecting foreign law to govern their commercial relationship (although this may be difficult to implement in the case of an on-going relationship). In short, instead of only excluding the abrupt termination regime, cut the Gordian knot and exclude French law altogether.

Interestingly, this decision was rendered by the International Chamber of the Paris Appeal Court. This chamber, along with the International Chamber of the Paris Commercial Court, was created to attract international disputes in Paris after the Brexit referendum. It offers the possibility of conducting proceedings in English while following procedural rules that common law lawyers are familiar with, such as discovery or cross-examination of witnesses.

The International Chamber's position is yet to be confirmed by the French Supreme Court. In the meantime, it will certainly influence other chambers of the Paris Appeal Court and, more generally, Commercial Courts in France because the International Chamber is specialised in international private law matters and the Paris Appeal Court has exclusive jurisdiction over all appeals involving an abrupt termination claim.

The fact that the Court limited the scope of application of the abrupt termination regime and decided instead to rely on the parties' choice of law, can clearly be seen as a pro-business stance. In this regard, whatever happens next, there is no doubt that this will remain the first landmark decision of the Appeal Court's International Chamber.

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First German decision holding credit rating agency liable to investors

The German courts have taken the liability of credit rating agencies to the next level. In a series of recent decisions, the Berlin Regional Court has developed criteria under which credit rating agencies may be held liable for bond ratings under German domestic law. This development has included the first German decisions in which investors were awarded damages against a credit rating agency. The German decisions fit into a wider global pattern of attempts to hold credit rating agencies liable.

An emerging field of litigation

Courts in all jurisdictions dealing with investor claims against credit rating agencies face the same difficulty when ratings are addressed to the general public: How can you protect investors relying on ratings and at the same time keep the liability of credit rating agencies within reasonable and insurable limits? Furthermore, liability risks may create an incentive for credit rating agencies to give lower ratings. This can lead to higher interest rates.

Accordingly, decisions holding credit rating agencies liable are rare in all jurisdictions. Irrespective of the legal system, the threshold for liability is high. Plaintiffs regularly fail to meet, for example, the standard that a rating was 'provably false'.

> "Decisions holding credit rating agencies liable are rare in all jurisdictions."

Legislators have tackled the issue with additional rules. The U.S. enacted the Credit Rating Agency Reform Act in 2006, followed by the Dodd-Frank Act in 2010. In the EU, the Credit Rating Agency/CRA regulation became effective December 2010 and, after an amendment in 2013, provides for civil liability of credit rating agencies. This liability regime applies in addition to the national rules of the Member States.

These rules have not yet generated many decisions; however, some courts begin to cover new ground:

- In 2009, the California Public Employees' Retirement System (CalPERS) brought an action in California state court for negligent misrepresentation against several credit rating agencies. California's Court of Appeal found that CalPERS demonstrated a likelihood of success on the merits for holding the credit rating agencies liable for negligent misrepresentation under California law for their ratings of privately placed securities. Subsequently, two credit rating agencies settled for USD255 million.
- In 2014, the Federal Court of Australia held a credit rating agency liable for unreasonable, unjustified and misleading ratings.

The decisions of the Regional Court in Berlin point in the same direction.

The decision of the Berlin Court

The Berlin Court, in May 2020, ruled in favour of investors who sued a German credit rating agency for the breach of a duty of care for a bond rating. The Court based the decisions on German domestic law rather than the EU CRA regulation, since the bond had been issued and rated before the EU CRA regulation became effective. Liability under domestic law is based on the idea of a 'contract-like' relation between the credit rating agency and the investors. This concept was developed by German courts, inter alia, with regard to the liability for expert opinions. Under specific circumstances experts can be held liable by parties who could reasonably be expected to rely on the expert opinion even if they do not have a contract with the expert. Similarly, the Regional Court in Berlin found a 'contract-like' relation between the buyers of the bond and the credit rating agency because of the following factors:

- the credit rating agency was publicly registered under the EU CRA regulation;

– the case concerned a bond rating and not an issuer rating, thus limiting the total liability of the credit rating agency to the buyers of the bond;

– the credit rating agency knew the principal amount of the bond issue and so knew its maximum liability; and

– the credit rating agency knew that the rating would be used to promote the distribution of the bond.

Under these circumstances buyers of the bond have the same rights as if they had a contract with the credit rating agency, the standard being negligent breach of a duty of care – not 'gross' negligence. The Court found a breach of the duty of care. The bond had been rated 'A' whereas the issuer had been rated only 'CCC'. In the view of the Court there was no reasonable justification for this discrepancy. Further, the issuer's only security was a ship, which at the same time served as the main source of income. The credit rating agency valued the ship with a higher value than it carried in the issuer's balance sheet and failed to apply any form of margin.

Liability of rating agencies becoming more likely

While agreeing in principle with the concept of liability, another chamber of the Regional Court in Berlin, in 2019, had found no breach of a duty of care in a case concerning the same bond rating. Therefore, it is not surprising that the CRA appealed the decisions holding it liable. Irrespective of the outcome of the pending appeals, the decisions of the Regional Court in Berlin illustrate the increased liability risks for credit rating agencies in Germany. This may also extend to U.S. credit rating agencies as the German Federal Court of Justice confirmed that German courts may have jurisdiction if the credit rating agency has assets in Germany.

The next chapter will concern the liability regime under the EU CRA regulation. These rules pose a plethora of new questions: To what extent will breaches of the EU CRA regulation give rise to civil claims? And what is the exact scope of the liability regime? For instance, the Higher Regional Court of Düsseldorf (Germany) ruled in a decision, in 2018, that investor claims for issuer ratings were not covered by the European liability regime. The Court was criticised because it did not refer the case to the European Court of Justice to clarify the interpretation of the European liability rules.

What is certain is that we can expect more claims against credit rating agencies. It will be worth keeping a close eye on German and European decisions in this field.

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