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BREXIT – where next for your business?

"…Now, what I want is, Facts…in this life we want nothing but Facts, Sir…."
(Thomas Gradgrind, Hard Times)

BREXIT – where next?

Introduction

In our March briefing entitled ***Brexit** – **where next for the United Kingdom?*** we examined some of the *macro* issues that would arise in the event of an ***"Out"*** vote in the forthcoming EU referendum.

The present briefing is directed towards issues of a *micro* nature – what are the likely consequences of Brexit for various strands of the business sector? Many media commentators and interviewees have expressed a craving for ***the facts*** to help them make a decision about the forthcoming referendum– a desire that reminded the writer of the Dickensian quotation reproduced above. Yet, at the risk of the lawyer's traditional pedantry, the *future* holds no facts – it holds only speculation, possibilities, guesswork and the hope of better things to come. ***Facts*** belong to the *past* and the *present*. These unchallengeable propositions apply as much to business and national economies as they do to life in general.

But if the fact-seeker will inevitably be disappointed, it is nevertheless necessary to engage in some (hopefully) informed speculation about the likely consequences of Brexit for businesses operating in the United Kingdom. Planning for the future is always necessary, even if it rests on a significant degree of speculation and, hence, uncertainty.

This briefing will seek to identify the implications of Brexit for various business sectors. From a legal perspective, this is perhaps the only way to approach the subject, but the issues do not neatly divide into separate compartments. For example, it may be possible to identify specific regulatory consequences for the City of London and the wider financial services industry. But in truth this will only be a part of the equation because a regulatory framework is only one aspect of the business picture. Banks could conceivably be disadvantaged by restricted access to other markets, the loss of

Fladgate LLP 16 Great Queen Street | London WC2B 5DG
T +44 (0)20 3036 7000 | F +44 (0)20 3036 7600 | www.fladgate.com

any status that the UK enjoys as a "gateway" to the EU, reduced ability to recruit talented staff from overseas markets, and similar matters. In addition, a national economy is inextricably interconnected. If Brexit reduces export opportunities for the UK's manufacturing and services industries, then the banking industry will inevitably suffer as well. So the consequences of Brexit will be the sum total of a very large number of moving parts.

As we pointed out in our March briefing, the complexities and uncertainties are compounded by the need to negotiate an exit agreement, which, amongst other things, would have to address ongoing trade relationships. The content of such an agreement is entirely at large; it may be dictated more by politics than by any perceived economic good sense. The debate has periodically turned to the Norway option, the Switzerland option, with honourable mentions of the possibility of a trade deal that replicates Canada, the Ukraine or Albania. The blunt truth is – no one really knows, because negotiation of such arrangements involves many more parties than just the United Kingdom itself. It is possible to draw parallels with the Scotland independence referendum, where the Scottish Government built its case on the twin pillars of a currency union with the United Kingdom and continued membership of the European Union. Yet it could not guarantee those outcomes in the absence of cooperation from the other parties involved. The ***"Out"*** campaign now finds itself in an analogous position; it has plenty of ideas for a continuing relationship with the remainder of the EU, but lacks the ability to deliver them on a unilateral basis. So, once again, those with a Gradgrindian mindset must brace themselves for a disappointment.

With all of these reservations, it is nevertheless possible to outline a few observations in relation to a number of business and related issues. Given that one of the avowed objectives of the ***"Out"*** campaign is to allow the UK to reclaim sovereignty over its own affairs, it will also be pertinent to note the extent to which this might be achieved in each case.

With these considerations in mind, it is proposed to examine the possible impact of Brexit on (i) various business sectors, (ii) certain types of contracts and (iii) certain official and corporate issues.

Business sectors

Brexit + 1

At the outset, it should be borne in mind that – at least in legal terms – nothing will actually change on the day following an ***"Out"*** vote. The UK will give notice of its withdrawal from EU and a two-year negotiation period will ensue. The UK will remain a member of the EU for the term of such negotiations and all aspects of EU law will continue to apply during that period. In other words, for all business areas, the EU legal and regulatory framework will stay in place until a replacement arrangement has been negotiated under the exit agreement.

Market reaction will of course be more immediate but that issue falls beyond the scope of a legal analysis.

Banking and financial services

Given the importance of the financial services industry to the UK economy, that field offers an appropriate starting point for the discussion.

Perhaps the best known aspect of EU financial services law is the so-called "passporting" system. This allows banks, insurers and investment firms authorised in one Member State to establish branches/subsidiaries in other Member States without any requirement for further local permissions. Supervision and investor compensation schemes are then the responsibility of the "home" – as opposed to the "host" – Member State.

If an acceptable substitute framework cannot be negotiated, then the UK would sit outside the passporting area. The immediate consequences would include:

a) UK banks and their subsidiaries operating within the remainder of the EU would require authorisation from supervisors within those Member States. The best route may be for a UK institution to establish a subsidiary within an EU Member State and, thence, to passport that subsidiary across the rest of the EU. But such an approach may in some cases require significant corporate reorganisation;

b) from the “inward” perspective, EU banks and investment firms would be unable to maintain branches/provide services within the UK. They would require authorisation from the appropriate UK regulator for that purpose. Given the large number of EU banks that have branches in London, this could lead to a significant increase in the workload of the Prudential Regulation Authority. This will not, however, be a novelty for the UK regulators – branches of third country banks are currently supervised on this basis.

This suggests that the financial services industry in both the UK and the EU has much to lose from the UK’s withdrawal from the passporting system and that, consequently, a deal should be struck to preserve that arrangement in the post-Brexit era. However, as in the case of many other matters relating to “single market” access, there will be many political hurdles to overcome and the UK would doubtless have to make a contribution to the budget.

If no such deal can be struck, then the UK may resume its sovereignty and control over the supervision and conduct of all financial services activity within the UK. But it should not be thought that the UK will enjoy complete autonomy or discretion in these areas. For example:

a) at present, the UK implements the EU’s Capital Requirements Directive, which requires the financial services industry to maintain capital to cover the risks to which it is exposed. However, these rules are ultimately derived from Basel III, issued by the Basel Committee on Banking Supervision. As a practical matter, the UK would therefore still be expected to implement these rules in any event. Whilst the required provisions could therefore be presented in a different way and there may be more flexibility at the edges, the substance of these requirements would remain the same, regardless of Brexit;

b) the UK also implements and applies EU legislation in the sphere of anti-money laundering and terrorist finance. Once again, however, these rules have a higher derivation – in this case, the recommendations of the Financial Action Task Force, an agency established by the G20. The UK would thus again have to follow essentially similar rules, albeit via a different strain of authority; and

c) the same general remark may be made about the European Market Infrastructure Regulation (**EMIR**), which provides for collateral and clearing arrangements in relation to derivatives transactions. Once again, EMIR flows from a G20 commitment, and the UK would still need to implement these rules, even though this would be done at a UK (rather than EU) level.

In view of the above points, it must be doubtful whether Brexit can lead to a bonfire of regulations as far as the financial services industry is concerned.

There is a variety of other “market access” issues that may be relevant to distinct sectors:

a) *Investment firms*. At present, firms engaged in selling/managing/advising on investments can passport into the rest of the EU on the same basis as banks (above). Under the new Markets in Financial Instruments Directive (**MiFID II**), it will be possible for a post-Brexit investment firm to offer its services to retail investors in the EU but it would still be necessary to open a branch within the EU and to comply with EU capital requirements.

b) *Insurers*. A number of UK insurers make use of the financial services passport to establish branches/provide services within the EU. Post-Brexit, insurers and brokers would lose this right. The most important legislation affecting insurers at present is Solvency II, which primarily regulates the amount of capital that insurers must hold. The implementation of these rules has been controversial but the PRA has supported the essential principles. It is thus perhaps likely that – as for banks – Brexit would not offer any great relief from the regulatory and compliance burden.

c) *Clearing houses*. Once again, clearing houses (or central counterparties) benefit from an EU passporting system under EMIR. Post-Brexit, it would be necessary for central counterparties to obtain “third country” status in order to continue this business within the EU. Although the essential principle is the same as that discussed above in relation to other sectors, the practicalities in this particular sphere may be much more complex. Specifically, the EU Commission previously proposed measures that would have restricted the clearing of euro-denominated derivatives to entities established within the Eurozone itself. The UK successfully challenged this move before the European Court of Justice, and the issue was later settled. However, post-Brexit, it is easy to imagine that this point would return to the agenda, and the UK would then have no further right of challenge in an EU forum.

d) *UCITS schemes*. These schemes are designed to facilitate retail investment into liquid markets. Following Brexit, the UK would no longer be party to the relevant EU legislation and UK firms could not market such funds into the EU, unless “equivalence” arrangements were negotiated (see below). Once again, this would effectively require UK firms to comply with requirements imposed at an EU level, notwithstanding Brexit.

e) *Alternative investment funds*. The rules governing the marketing of alternative investment funds (e.g., private equity funds) are very similar to those applicable to UCITS schemes. Essentially the same position would thus again apply.

f) *Prospectus rules*. Under the Prospectus Directive, a “passport” system applies to a prospectus. Thus, if a prospectus has been approved by the Listing Authority in the UK, it can be used for marketing purposes in other Member States without further approval. This flexibility would obviously be lost post-Brexit. This would complicate efforts to achieve a dual listing for securities in London and on another EU exchange.

Real estate

Historically – and even before the UK originally joined the European Communities in 1973 – the UK did not impose restrictions on foreign ownership of real estate in the UK, whether residential or commercial. The current situation is that any such restrictions would be an infringement of the EU's rules on free movement of capital. Subject to the terms of any Brexit agreement, it would be open to the UK to introduce such restrictions. On the whole, however, the UK has always maintained its openness to foreign investors.

Various issues have arisen in the UK residential market in recent years, e.g., the lack of transparency where high-value properties have been held through offshore vehicles. However, these problems have been addressed through changes to the tax system (in particular, with reference to stamp duty). Recent moves to force the disclosure of beneficial owners of properties held through offshore corporate vehicles may also limit activity in this market but these initiatives are lawful irrespective of the UK's membership of the EU.

It may be that Brexit would allow the UK to introduce a more orderly approach to its home finance market. At present, the rules governing personal lending are something of a patchwork quilt, comprising the Regulated Activities Order, various rules of the Financial Conduct Authority and the newly-effective Mortgage Credit Directive. In some cases, it is necessary to consider the Consumer Credit Act 1974, rather untidily overlaid by the EU's Consumer Credit Directive. But this would probably amount to a tidying-up exercise, as opposed to a more wholesale reform.

Even in the context of high-end or commercial property, it seems that Brexit would not have any specific consequences of a legal nature. The main practical implications may include:

a) a reluctance on the part of foreign investors to place funds into UK properties if the country ceases to be seen as a "gateway" to Europe; and

b) perhaps as a result of (a) above, a reduction in the levels of bank finance that may be available to support this market.

Aviation

The EU operates an open aviation market, which allows carriers based in any EU Member State to operate freely throughout the EU. The EU has also negotiated air service agreements with other countries and has an "open skies" agreement with the USA.

If the UK ceases to be part of the EU, then it would have to negotiate its own arrangements with the EU – possibly through membership of the European Common Aviation Area or through a separate bilateral agreement. In addition, it may have to negotiate new agreements with the USA and other non-EU countries.

Contractual issues

Financial contracts

When it appeared possible that Greece could be forced out of the Eurozone, much time was spent in examining the possible implications for financial contracts with Greek counterparties. The departure of Greece could have caused complex legal problems. Specifically, would continuing contracts have to be settled in euro, or would the Greek counterparty be entitled to settle its obligations in the (presumably depreciating) new Greek currency?

In contrast, the UK has retained its own currency and that particular issue will not therefore arise. It is, however, necessary to consider whether Brexit might have any other consequences for financial and other contracts.

Most loan agreements will contain a variety of undertakings that are designed to allow for termination or renegotiation of the facility in the event of a breach. These may include interest cover and minimum net worth covenants that may be triggered if the loss of market access to the EU results in a

significant fall in revenues, or in write-offs. Nevertheless, these clauses were clearly not designed with Brexit in mind and they could potentially be invoked under a wide variety of other circumstances.

Slightly more difficult issues arise in the context of the "material adverse change" clause, which is almost invariably found in the default clause in loan agreements and in other financial contracts. The clause will generally allow the lender to accelerate the loan if (i) a change in circumstances occurs and (ii) that change is likely to have a material and adverse effect on the borrower's business or its ability to perform its obligations to the lender. Again, this clause was not specifically framed with reference to Brexit, but it is easy to see its potential application in that context. A UK borrower which depends significantly on business with UK customers may find that its material adverse change clause could be triggered by Brexit. The significance of this point will obviously vary from borrower to borrower and will have to be judged on an individual basis.

A radical and unforeseen change in circumstances may lead to the termination of a contract through the operation of the doctrine of frustration. However, there are various reasons why this doctrine should not apply in relation to financial contracts. The main point is that a monetary obligation cannot normally be the source of the doctrine, since all borrowers are legally responsible for their own solvency, without excuse by reference to external events. Thus, if a UK borrower was unable to service its euro-denominated debt because of the loss of contracts with EU customers and a post-Brexit fall in the value of sterling, the contract would nevertheless remain valid, effective and enforceable. The doctrine of frustration could not in any event apply after the proposal for a Brexit referendum was announced since, at that point, it became a foreseeable event.

Finally, it should be borne in mind that the enforcement of contracts against foreign counterparties may become more problematic. At present, EU regulations provide for the reciprocal recognition and enforcement of judgments obtained in Member States. If the UK ceases to be part of the EU, then the processes for enforcing judgments of the English courts against contracting parties within the EU may become more protracted and expensive.

Employment contracts

It is not easy to anticipate the effect of Brexit on UK employment law.

On the one hand, UK employment law has been heavily influenced by EU law. It might therefore be thought that there would be significant scope for a reduction of regulation in this sphere. In addition, in negotiating a post-Brexit agreement, the EU is unlikely to have a priority interest in seeking to shape the UK's future policies in the social and employment fields. It would therefore be reasonable to expect that – in the post-Brexit era – the UK would be left with a significant degree of discretion to reshape its employment laws.

On the other hand, much of EU employment law has now become an accepted part of UK law and seeks to ensure equality of treatment, non-discrimination and similar matters. Any perception that Brexit could be used as a pretext for diluting standards of employee protection is therefore likely to meet with significant opposition from trades unions and others within the UK itself.

It therefore seems likely that Brexit will have the effect of repatriating sovereignty in employment law. However, practical considerations may inhibit immediate and wholesale changes in this area – gradual reform over a much longer period seems to be the more likely outcome.

For employers, the more immediate impact of Brexit is likely to be felt in the immigration sphere. Many companies may have employed migrants from other parts of the EU for a number of years, and they would need to consider whether they will be in a position to retain such staff. As noted earlier, however, there will be a two-year negotiation period during which such staff will continue to enjoy their right to work in the UK. Even then, established residents are likely to be allowed to remain – the spectre of a wholesale expulsion of EU nationals from the UK is not likely to appeal to many politicians.

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Other contracts

The position may however be more nuanced for contracts that are not of a purely financial character. For example, if a US company has entered into an English law joint venture or distribution agreement with a UK company designed to exploit a customer base in the EU, then the possibility that such a contract could be frustrated by Brexit must be distinctly higher. This follows from the specific EU-nexus of the agreement at issue, and the fact that the precise status of the UK's post-Brexit trading position with the EU may take some time to emerge.

It has also been reported by Sky News (4 May 2016) that a contract for the acquisition of Charter Court included a clause that the contract would be terminated in the event of a vote in favour of Brexit. Clauses of this kind do not seem to have become widespread and, in any event, they would only be appropriate until the referendum result is known. If Brexit is perceived to damage possible business deals after that, then parties simply will not enter into them in the first place.

Official and corporate issues

State aid and public procurement

As an EU Member State, the UK is generally prohibited from providing government assistance to industrial sectors that may be running into difficulties. As a result, certain assistance given to UK banks during the 2008 financial crisis required the approval of the EU Commission. It is likewise prevented from providing governmental incentives to attract foreign investors into the UK markets.

In similar vein, government contracts must be subjected to an open system of bidding and thus cannot be used, for example, as a means of creating jobs in areas of high unemployment.

Following Brexit, the UK would no longer have to apply these rules and thus may enjoy greater flexibility in the context of its wider economic policies. The extent to which such freedom might be used in practice may be a separate question, but this would appear to be an area in which Brexit would reclaim a significant degree of national sovereignty.

Taxation

Historically, EU Member States have jealously guarded national sovereignty over their domestic systems of corporate and personal taxation. However, over the years, the European Court of Justice has made inroads into this principle, generally on the basis that national tax rules inhibit the exercise of the freedom of establishment or are contrary to treaty rules preserving the free movement of capital. In particular, the UK's "controlled foreign company" rules were found to detract from the freedom of establishment, and HMRC was compelled to make large tax refunds to affected companies.

If Brexit and the negotiated agreement had the effect of freeing the UK from these principles, then the UK would reacquire a much greater degree of sovereignty over its national tax system.

Monetary and exchange rate policy

It is widely thought that – given that it remains outside the euro area – the United Kingdom retains complete sovereignty in relation to its currency and the pound sterling. Yet this is not entirely accurate.

It is true that, in relation to monetary policy, the Treaties confirm that the UK retains its powers in this area. ***Monetary policy*** comprises the level of interest rates and the amount of money in the economy, so the UK is free to set sterling interest rates and to engage in "quantitative easing".

But in contrast, ***exchange rate policy*** refers to the targeted relative strength of sterling against the euro and other currencies. The UK's sovereignty in this area is not at present complete, because the Treaties provide for the UK to treat its exchange rate policy "… *as a matter of common interest*…" This appears to mean that the UK cannot engage in measures to devalue sterling with a view to obtaining a competitive advantage over other EU countries. This obligation would cease to apply if the UK left the EU, and it would thus have greater powers over the management of its own currency.

The practical effect of this restoration of monetary sovereignty may, however, be open to debate because:

a) the UK has allowed sterling to float freely and has abstained from intervention in the currency markets ever since 1992, when sterling ignominiously fell out of the EU's exchange rate mechanism; and

b) currency manipulation designed to secure a competitive advantage is also prohibited by the Articles of Agreement of the International Monetary Fund, and the UK will of course remain a member of that organisation.

Corporate measures

Companies whose business depends on the EU to any material extent (whether in terms of supplies, customer base or other matters) will need to keep a close eye on developments in the UK's trade negotiations with the EU. The imposition of tariffs or other measures could have a significant impact on both the cost of supplies and sales, and on the competitive position of the company as a whole.

In an extreme case, the trade consequences of Brexit could push a company towards insolvency, and the directors would have to consider whether the company remains solvent and able to continue its business in the face of those developments. This assessment may be especially difficult because, as noted above, the precise details of a new trade deal may take up to two years to emerge.

The possible impact of Brexit on material adverse change clauses in loan agreements has already been noted. In some cases, it may be necessary for companies to engage with their lenders to ensure that the clause will not be triggered in their particular case.

Data protection

Brexit would relieve the UK form its obligations to comply with EU data protection laws which, in some quarters, are perceived to be cumbersome. The UK could thus design its own regulatory system for the protection of data privacy.

Whilst this may in some respects be a positive step, a new regulatory structure may have to be acceptable to other EU Member States, so that subsidiaries established in those countries would still be able to share data with branches and affiliates within the UK. It may therefore be that UK companies will have to rethink their data protection policies in the light of this potentially significant change.

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Conclusions

For the reasons given at the outset, it is impossible to state any conclusions of a ***factual*** nature and, in any event, a briefing of this kind can only provide an overview of selected areas. But it is possible to state a few tentative observations.

First of all, it seems quite likely that Brexit will result in the United Kingdom reclaiming its sovereignty in a variety of areas. As noted above, this may especially be the case in the context of governmental involvement in the national economy, and in the sphere of taxation.

In other areas, however, sovereignty may be more illusory than real. For example, it will be necessary to strike some sort of deal with the EU to maintain access to the single market in financial and other services. It is unrealistic to expect that such access will be granted unless the UK regulatory system operates on a broadly reciprocal basis.

This briefing has been prepared by Charles Proctor, the head of our banking and finance team. It does not necessarily reflect the views of the firm as a whole.

Further information?

Charles Proctor
Partner
T +44 20 3036 7324
E cproctor@fladgate.com

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