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BREXIT:

Documentation issues for lenders and hedge providers

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Introduction:

We set out below our thoughts on how a Brexit will or could impact on Facility Agreements and loan linked hedging agreements. A UK vote for a Brexit would amount to a major change to the UK legal landscape, and our conclusion is that the likelihood is that holding legislation will be required in the UK to preserve the continuing operation of much EU derived law for some (perhaps a considerable) period of time. Notwithstanding that conclusion, we have analysed in detail the possible impact of a Brexit below.

Please see the glossary/jargon buster at the end of this briefing paper for an overview of certain terms/references used in this document.

Background

With the referendum on UK membership of the EU set for 23 June 2016 now is an appropriate time to review the possible consequences for loan and swap documentation[1] should the vote be to leave (a "**Brexit**"). At this stage the analysis can only be a preliminary one.

Numerous regulatory, operating and other issues would arise for lenders and hedge providers as a result of a Brexit, particularly in relation to the "single passport" which allows EU based financial services institutions to operate across Member States. We will address these issues elsewhere.

There are significant differences in the legal systems within the UK, particularly between England (including Wales for many purposes) and Scotland, and the Scottish National Party has already indicated that its preferred course on a Brexit may be for Scottish independence within the EU. Our comments below are, however, largely limited to finance documentation governed by English law.

Leaving the EU

An "out" vote would require the UK to take steps to implement its exit from the EU. The mechanism used would probably be Article 50 of the Treaty on European Union, which provides that a member state wishing to leave the EU must give two years notice of its intention to withdraw, but that period may be extended.

A key question is how the UK could then retain access to the single market without accepting EU regulation, the free movement of EU citizens, and budgetary transfers to the EU. The UK would also have to try to strike trade deals with non-EU countries such as the US, India, China, Japan and Australia.

What new arrangements might be put in place is a matter for speculation. The possibilities include a Norwegian model of the UK joining the European Economic Area (the "**EEA**"), a Swiss model of negotiating access to the EU's single market by a series of bilateral agreements with member states, a World Trade Organisation model relying on rights and obligations under the WTO rules, and negotiating a series of unilateral treaties (which would be extremely difficult in the short term). The Norwegian and Swiss models would require the UK to comply with many present and future EU regulations, but without having a "seat at the table" in their negotiation and development.

After over 40 years of EU membership, EU law is deeply embedded in the UK. EU Regulations are "directly applicable" in all Member States but would presumably cease to apply in the UK on a Brexit, unless replicated or preserved by new legislation here. EU Directives apply as implemented in the UK, sometimes by primary legislation, but more often by various forms of secondary legislation pursuant to section 2 of the European Communities Act 1972, and this may affect how far such legislation would automatically fall away. In any event, simply allowing all UK domestic law derived from the EU to lapse, or revoking it, would be unworkable in the short term. Some form of overarching UK legislation to preserve existing legislation and to address basic legal uncertainties caused by a Brexit would seem inevitable[2].

General Brexit issues for finance documents

Governing law

English law facility documentation will almost invariably contain an express choice of law provision. ISDA Master Agreements contain such a provision in standard form, albeit that the actual choice of law is a Schedule elective. The current EU rules on governing law are set out in Rome I and II Regulations. One choice for the UK would be to leave the substance of these rules in place, but under the supervision of the UK courts. Another would be to fall back on the rules in place in the UK immediately before those Regulations. In the case of contractual obligations these were contained in the Rome Convention, which is broadly similar to Rome I, and respects the parties' choice of law. Courts elsewhere within the EU would presumably continue to respect the parties' choice of governing law in an English law document, because they would continue to apply Rome I and II.

Jurisdiction

Facility documents will also usually contain a submission to jurisdiction; that the courts of England have exclusive jurisdiction to settle disputes, but with a right for the finance parties to take proceedings or concurrent proceedings elsewhere. There will often also be security documents governed by appropriate local laws in respect of assets located outside England. Obligors incorporated outside England will usually be required to appoint a process agent in England for service of legal proceedings. ISDA Master Agreements contain comparable provisions as standard.

[1] This note confines itself to swap documentation that is used to document vanilla interest rate and currency hedges for loan finance transactions. Our Derivatives and Structured Finance Group will be issuing a dedicated note on the impact of a Brexit for derivatives generally and for repo, stock-lending and bonds
[2] Certain regulations in the derivatives arena that are the result of global regulatory initiatives, most notably EMIR, are in our view likely to be adopted wholesale by a post-Brexit UK government.

The Recast Brussels Regulation currently sets out which courts of EU Member States have jurisdiction in civil and commercial matters, and provides for mutual recognition and enforcement of civil and commercial disputes within the EU. The general rule is that the courts where the defendant is domiciled have jurisdiction, but this is usually "trumped" where the parties have agreed that the courts of another Member State should have jurisdiction, or where assets such as real estate are the subject matter of the contract.

On a Brexit, the UK would probably accede to the 2007 Lugano Convention (currently in force in the EU, Switzerland, Norway and Iceland), which is broadly similar to the current EU regime in terms of jurisdiction, and would generally oblige EU courts to recognise a choice of jurisdiction provision in favour of the English courts in a finance document. Even without this, the English courts would still be likely to uphold an English choice of law provision, but how the courts of other Member States would regard such provisions would be a matter for their own laws, and might give rise to uncertainty.

If the UK did not accede to the Lugano Convention, there would be no bar to parallel proceedings, provided the courts in other jurisdictions were prepared to accept jurisdiction under their own rules of private international law.

At present, English law permits legal proceedings to be served outside the jurisdiction with the agreement of the parties, within the EU where the UK has jurisdiction under the Recast Brussels Regulation, or otherwise with the leave of the English courts. Unless the UK acceded to the Lugano Convention on a Brexit, which contains similar rules, the leave of the English courts might become necessary in order to serve proceedings in the EU.

Enforcement of judgements

The recognition and enforcement of judgements within the EU is provided for in the Brussels Regulation. Without that, and unless the UK acceded to the Lugano Convention, the enforceability of judgments of the English courts elsewhere in the EU would depend on the laws of each Member State. In some circumstances, this might increase the attractions of a decision for arbitration of disputes under facility documentation, using the enforcement mechanisms under the New York Convention, or for ISDA's own model arbitration provisions.

Substance of UK

As mentioned above, it is uncertain at this stage how far the UK government would decide to leave existing EU law in place as part of English law on a Brexit. Given how deeply EU law is embedded in UK law, whether being directly effective here, incorporated by secondary legislation, or simply referenced in UK legislation, some continuity post-Brexit would seem inevitable. If the UK opted for EEA membership, present and future EU legislation falling within the scope of the EEA Agreement would apply to the UK.

References to EU law in finance documentation

Facility documentation often contains references to particular legal enactments, including EU Regulations or UK legislation implementing EU Directives, such as the Financial Collateral Regulations or Rome I and II. The standard approach in finance documents is to include a term that a provision of law is a reference to that provision as amended and re-enacted. This means that the documents should be read as referring automatically to whatever may replace such EU derived enactment under English law, although there is clear scope for uncertainty and, in due course, a need to review documentation with this issue in mind. ISDA Master Agreements do not contain any such references as standard, although it would be prudent to check Schedules for bespoke provisions (including any related to EMIR) that may do so.

Currency

Some of the analysis done in recent years in connection with a possible Grexit (Greece leaving the euro or even the EU) may be relevant to a Brexit, but with the obvious difference that the UK has its own currency and so there would be no immediate impact on the single currency, nor on the currency of payment obligations under a facility or swap agreement.

Frustration and force majeure

A contract heavily dependent on EU legislation could in theory be frustrated by a Brexit, or a *force majeure* term might be triggered, particularly for a contract heavily dependent on the ongoing operation of particular EU legislation. But this seems relatively unlikely in the context of usual facility or swap documentation.

Facility Documentation

We briefly review below the provisions of facility documentation that might be particularly relevant in the event of a Brexit. As a general comment, loan documentation would be principally affected in the same way as other contracts. While we do not think that wholesale documentation changes will be made ahead of the referendum, we suggest a number of points that could be considered, and will become important if the vote is for a Brexit. Individual facilities may also raise particular issues. We reiterate, however, that some form of overarching UK legislation would be a necessity, and should deal with a number of the matters mentioned below, while industry bodies such as the LMA would no doubt feed into the debate and review its documentation at this stage.

Given that a vote for a Brexit would probably be followed by a period of negotiation of at least two years with the EU, there would be a window for review and potential renegotiation between parties to existing finance documents. Post-Brexit documentation would, as a minimum, require updating to correct references to EU legislation that was no longer applicable. A decision for a Brexit might, however, have a more immediate effect on the negotiation of new finance documentation.

Definitions and interpretation

In due course, references to EU Regulations and Directives no longer in force in England will need to be replaced. The standard term that references to a provision of law are to that provision as amended or re-enacted should mean that the relevant term should "update" to a replacement UK provision, assuming it can be said to "amend or re-enact" but as mentioned above, some sort of statutory measure to continue EU laws would seem inevitable in the short to medium term. Subject to that, many references to EU laws, such as to the Centre of Main Interests under the Regulation on Insolvency Proceedings, would presumably either continue to operate or would fall away as meaningless. Some Directives commonly referred to in a facility agreement, such as the Directive on VAT, would presumably have to be replaced by the UK, and the general interpretation provision mentioned above would apply to the UK replacement.

TARGET2, which is frequently defined, is the real time gross payment system for the settlement of euro transactions within the Eurozone and as such references to it seem likely to be unaffected. The Bank of England (and the Sveriges Riksbank of Sweden) do not participate in TARGET2.

Utilisation

Short of the facility agreement being frustrated (which seems highly unlikely) a Brexit would only affect the ability to draw or roll over advances if it constituted or triggered an event of default (or possibly potential event of default), or if repeating representations became untrue.

Optional currencies

There seems no obvious reason why a Brexit (as opposed to a Grexit or a wider collapse of the euro) should affect the optional currency provisions of a facility agreement.

Prepayment and cancellation

A Brexit seems unlikely to trigger the illegality provisions of a facility agreement unless the loss of the single passport means that lenders or their affiliates lose the necessary authorisations to perform their obligations and to continue as lenders. A loss of passporting rights may cause serious difficulties for financial institutions, but since a syndicated facility does not usually tie lenders to a particular lending office, still less to one in the UK, a Brexit seems unlikely in itself to trigger prepayment obligations.

Borrowers may seek to negotiate prepayment rights linked to a Brexit. That would be a matter for negotiation, but it is difficult to see that such rights would be justified for certain facilities where a Brexit ought to have no direct impact - for example, UK real estate financings.

Borrowers are likely in many cases to already have a right of prepayment of single lenders invoking tax gross-up provisions, tax indemnity or increased costs provisions.

Interest

No immediate changes to definitions of LIBOR or EURIBOR seem called for.

Market disruption

The drafting of such provisions varies, but lenders whose cost of funds is in excess of LIBOR will usually have a right to pass on increased costs, and a borrower may have a right to prepay that lender. If screen rates of interest become unavailable there are a number of potential fall-backs, including reference banks. At this stage it is probably unduly speculative to suggest that such provisions might be engaged or that the market-standard provisions should be heavily negotiated, although the Eurozone crisis saw a number of lenders considering whether they could invoke increased costs clauses in view of their difficulties in obtaining costs in the interbank markets.

Tax gross up and indemnities

As with much else in this briefing, the tax impact of a Brexit would depend on a number of factors, including the nature of the UK's future relationship with the EU. A Brexit would have no impact on the UK's network of double tax treaties, which is not based on EU membership, and there is no immediate reason to suppose that the withholding tax position under facility agreements would be adversely affected, or that the relevant provisions require amendment.

FATCA provisions are likely to be unaffected, since they largely depend on agreements with the US that are put in place at national rather than EU level, such as the UK/US agreement of September 2012.

The EU VAT Directives have been implemented in the UK by domestic UK legislation. A Brexit would not, therefore, cause the UK legislation implementing the VAT Directives to fall away automatically and VAT would continue to apply in the UK, although there could be an impact on cross-border supplies.

In relation to trade finance, a Brexit would mean that the EU Customs Duty Regulations no longer applied to the UK, leaving the UK without any customs duties, so the position would depend on what new arrangements were put in place.

Increased costs and other indemnities

Increased costs provisions for costs attributable to lenders having funded advances are usually tied to the introduction or change in law or regulation, with certain matters being excepted, often to prevent double counting. As such they seem likely to catch a range of increased costs that might apply from arrangements put in place on a Brexit, and it would appear unrealistic in most cases for borrowers to expect to exempt a Brexit from this, because that would depart from the traditional allocation of risk between lender and borrower. An argument that a lender should bear the risk of a Brexit because it can assess the impact it will have on it at this stage should not pass muster. CRD IV (the European legislation which implements Basel III) has come into force, but is sometimes dealt with expressly in an increased costs clause. We see no immediate reason to change practice on this.

Representations and undertakings

Representations would require review for applicability in the event of a Brexit. A representation such as that a borrower's COMI was and would remain in the UK might be analysed in a number of ways, and would ideally be amended or dispensed with. An argument that it was breached on a Brexit would seem unattractive.

The practical effect on undertakings to comply with laws would depend on the new legal structure post- Brexit, and the principles of construction used in the documents. Our assumption is that in the short term at least post-Brexit the UK will need to preserve EU -derived legislation in force, and that wholesale revisions to representations and undertakings would not be required. The number of express references to EU legislation in facility documentation is relatively few. To the extent borrowers remain subject to EU laws then representations and undertakings referring to such laws should and will continue to apply. Seeking to require compliance with EU laws no longer applicable in the UK would in most cases seem unreasonable. Undertakings such as compliance with laws will automatically pick up what is applicable to borrowers and their businesses from time to time.

Events of default

Those most likely to be relevant are probably misrepresentation, unlawfulness and material adverse change. Given the June date for the referendum, and the possible consequences for the parties, immediate inclusion of an event of default if the vote is for a Brexit is unlikely to be practicable or acceptable in any loan market transaction.

Material adverse change events of default differ between facility agreements. Recent case-law has slightly reduced the risks a lender runs in seeking to invoke an event of default a loan on the basis of material adverse change: if there is no event of default a demand will be ineffective, but failure to allow utilisation of the facility runs the risk of a damages claim. Invoking such a provision on the basis of a Brexit would probably be something of a last resort, although there might be situations cases where a Brexit was likely to be particularly detrimental to a borrower's business. In any event, a lender cannot usually invoke such a provision in relation to facts known at the time the facility agreement was entered into, which might be a further hurdle to be overcome.

Payment mechanics

It is difficult to say how payment mechanisms might be affected in the long term by a Brexit. Although payment services are subject to EU legislation, it would be unduly alarmist to suggest that a Brexit would cause issues for the interbank markets that would not be dealt with. At present there is no reason to suppose that a Brexit would trigger a Disruption Event (a material disruption to payment or communications systems) under an LMA style facility agreement, or that any specific amendment would be appropriate to such provisions.

Amendments and waivers

Bilateral facility agreements are likely to restrict amendments to their terms without the consent of both parties. Syndicated facilities usually permit variations and waivers with the consent of majority lenders (or of all lenders for "all lender matters") and of the obligors.

One option to consider is to include a right for the lender, or the lenders/agent, to amend the facility documents to the extent that it or they (perhaps acting reasonably and in consultation with borrower) determine is necessary (perhaps to reflect market practice) as a result of a Brexit. Borrowers may be expected to resist such a provision unless it requires their consent, but some such right for lenders to make amendments has been relatively common over the years, being either a general right, or one triggered by a particular contingency such as the UK adopting the euro (how distant that now seems!), a Grexit, or even a collapse of the EU (might that now be worth another look?)

Agency provisions

Agents and security trustees will no doubt review their duties and protections under a syndicated facility, and will no doubt take a cautious approach. It is conceivable that a Brexit would involve a considerable administrative burden, but in general the documents should already provide adequate protection.

Governing law and enforcement

Most of the reasons why parties choose English governing law for facility documentation appear to be unrelated to the UK's membership of the EU, and we see little reason at present why a choice of English governing law should not remain appropriate and effective.

Depending on the arrangements put in place on a Brexit, it is possible on a worst case scenario that the ability to serve proceedings before the English courts elsewhere in the EU may require the leave of the English courts. It would therefore become all the more important to require borrowers and security providers to appoint a process agent in England, which is, of course, already common practice.

Security Documents

Many of the general issues likely to arise from a Brexit have already been mentioned.

There is no reason at present to suppose that any security interest would be prejudiced by a Brexit. English law security creates a property right and this will remain intact regardless of a Brexit, although matters such as cross-border insolvency and enforcement regimes deriving from EU laws may throw up challenges. The lender's remedies under its security should be largely unaffected, although the right of appropriation of financial collateral derives ultimately from the Directive on Financial Collateral Arrangements and might be prejudiced by a repeal of the European Communities Act without some holding measure being put in place. Given the importance of the Directive to the UK financial markets, it is almost inconceivable that this will not happen.

Equally, there is no reason to suppose that lenders' contractual rights under English law guarantees will be adversely affected. Although a guarantee may be released by many steps taken without the guarantor's consent, in the absence of suitable protective wording, we would not expect a Brexit to prejudice guarantees in the absence of some exceptional provision or circumstances. The usual provision that the guarantee is not prejudiced by unenforceability or illegality of the guaranteed liabilities ought to remain effective, failing which there will be usually an indemnity of the lender to fall back on.

Swap documentation

Many of the considerations highlighted above with respect to facility documentation apply mutatis mutandis to swap documentation, subject to well understood differences between the two types of documentation. In our view, under standard ISDA Master Agreements, a Brexit is unlikely to trigger an event of default (including a breach of representation), an early termination event (including an illegality[3] or a force majeure event) or any of the standard disruption events applicable under relevant ISDA Definitions to vanilla interest rate and FX derivatives. There may, however, exist Part 5 provisions in individual Schedules (including cross-default provisions to a related loan agreement that is itself triggered by a Brexit) that lead to a different conclusion. As we have already intimated, EMIR is likely to be transposed into English law more or less wholesale and so will remain relevant. The implications of such a transposition for swap documentation containing provisions relating to EMIR are at this stage unclear, as is the issue of applicability of such provisions following a Brexit but pending transposition.

Conclusions

A UK vote for a Brexit would amount to a major change to the UK legal landscape. As we have said above, the likelihood is that some form of holding legislation would be required in the UK to preserve the continuing operation of much EU derived law for some (perhaps a considerable) period of time. Any revisions required to finance documentation in light of a decision for a Brexit, or even following a Brexit, may be comparatively modest, but at the very least a Brexit would spark off serious debate about long established practices, and it would clearly take time for market practice to adjust to accommodate the new landscape.

Many issues are likely to arise and many questions will asked if the vote is for a Brexit. Please speak to your usual contact at Fieldfisher for assistance with these.

[3]Unless a loss of passporting rights gave rise to an illegality, in which case, under a 1992 Master Agreement at least, the “transfer to avoid termination event” provision would operate to provide a potential cure.

Glossary of References used in this Briefing Paper

EU Regulation	A regulation is a legal act of the EU that becomes immediately enforceable as law in all member states simultaneously.
EU Directive	A directive is a legal act of the EU, that requires member states to achieve a particular result without dictating the means of achieving that result. It can be distinguished from regulations which are self-executing and do not require any implementing measures.
Rome 1	Regulation (EC) 593/2008). The purpose of this regulation is to harmonise/standardise the position across the EU in terms of what governing law a court will apply to resolve a contractual dispute.
Rome 2	Regulation (EC) No 864/2007. The purpose of this regulation is to harmonise/standardise the position across the EU in terms of what governing law a court will apply to resolve disputes involving non-contractual obligations.
Recast Brussels Regulation	Regulation (EU) 1215/2012. The purpose of this regulation is to recast the European law on the recognition and enforcement of judgements in civil and commercial matters in courts in the EU.
New York Convention	A code relating to the enforcement and recognition of arbitral awards within contracting states (applies to countries in the EU and beyond, providing the relevant country has contracted in).
Financial Collateral Regulations	English laws that came into force in 2003 to implement EC Directive 2002/47/EC. Amended in 2009, and in 2010 by the Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010 (SI 2010/2993) (FCA Amendment Regulations 2010). These came into force on 6 April 2011. Laws that deal with security interests and title transfer arrangements relating to "financial collateral" and amend other English laws in this respect.
LMA	The Loan Market Association. A London based market body set up in 1996 to promote consistency and efficiency in the loan markets.

Centre of Main Interests (COMI)	A term that describes the jurisdiction with which a company or person is most closely associated with for cross border insolvency proceedings.
Regulation on Insolvency Proceedings	Regulation (EC) 1346/2000. introduces conflicts of law rules for insolvency proceedings concerning debtors based in the EU with operations in more than one member state, giving particular prominence to insolvency proceedings commenced in the member state where a company has its COMI (see above).
FATCA	Foreign Accounts Tax Compliance Act – US withholding tax legislation that has cross-border implications.
CRD IV	CRD IV Directive (*2013/36/EU*) and the Capital Requirements Regulation (*Regulation 575/2013*) (CRR), replaced the Capital Requirements Directive (*2006/48/EC* and *2006/49/EC*). Key implementation directive for the Basel III reforms, relating to prudential capital requirements for credit institutions and investment firms.

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