Brexit Q & A's: Finance and Financial Services

June 2016

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The Brexit process

What is the mechanism for leaving the EU?

The UK government is likely to use Article 50 of the Treaty on European Union, under which a member state wishing to leave the EU must give notice of its intention to withdraw (a period of negotiation of two years is envisaged). That period may be extended with the agreement of all 27 remaining member states. Reaching the end of the two year period without such an agreement, and without all 27 member states accepting an extension, would result in the UK leaving the EU with no immediate replacement agreed. Any analysis of the long term consequences of Brexit is necessarily speculative at this stage, until the UK's future relationship with the EU is settled.

What will happen next?

Today the UK will still be a member of the EU. A period of intensive negotiation of the terms of exit is likely to follow. It is conceivable that the EU will offer further concessions in an attempt to head-off Brexit, but difficult to see how this would be compatible with the Brexit vote. The Prime Minister has consistently stated that given a vote for Brexit he would have no choice but to serve a notice under Article 50 without delay, but with his decision to resign, the likelihood is that such notice will not be served immediately. In any event, this only starts the Brexit process. For the next two years at least the UK will almost certainly remain an EU member.

To bring about the UK's departure from the EU as a matter of **domestic law**, primary legislation would be required. This would involve the repeal or amendment of the European Communities Act 1972, accompanied by a decision on what elements of current UK laws derived from EU law should remain in place and what should be repealed, amended or replaced. In the short to medium term much EU derived law is likely to remain in place.

In the event of a further referendum on Scottish independence, there might be parallel negotiations for the UK to leave the EU, for Scotland to leave the UK, and for Scotland to join the EU.

Will the UK lose access to the single market?

Without negotiating fresh trade agreements with the EU, the UK is likely to lose free access to the single market. Whether the UK can negotiate such access without accepting the free movement of EU citizens and budgetary transfers to the EU is impossible to answer at present.

The loss of "passport rights" (i.e. the right for a UK financial institution to carry out regulated activities in another EU jurisdiction) could have potentially serious consequences for UK institutions and the ramifications of this would need to be worked through both nationally and by individual firms. One option for financial institutions relying on the passport granted under single market directives in carrying out business throughout the EU from a base in the UK is to relocate to another EU country. Many factors would impact the relocation issue including those relating to consolidated supervision and regulatory capital considerations. Where the EU legislation provides for institutions authorised in countries with equivalent levels of legislation to enjoy special access rights, no doubt the UK would look to obtain status as such a country. Under MiFID 2 financial services businesses based outside the EU could in principle benefit from an ESMA registration regime for third country entities operating in wholesale markets. The UK having an equivalent financial regulatory regime would be a precondition to benefitting from this although this is not a given, notwithstanding the UK being stricter in several regulated areas or conforming with international regulatory standards that are followed by most major financial centres (including the EU).

Many established financial institutions do of course already operate in a number of European jurisdictions and for them it would be more a reorganisation rather than a relocation.

It appears that the UK will also have to try to strike trade deals with non-EU countries where the EU has a trade deal, because on Brexit the UK will no longer benefit from the existing trade deals between the EU and those countries although membership of the WTO may replicate the position for a number of important jurisdictions.

Note incidentally that this issue is not just one for looking on a passport out into Europe by a UK financial institution but the challenge of deciding how financial institutions organise passporting in rights : there would need to be a review of how these arrangements could continue to work– or have to be reinvented.

What might the new structure look like?

Many commentators think that the likelihood is that the UK would end up with its own special new structure which does not follow any particular model currently enjoyed by another European country.

The most likely outcome appears to be a period of some years while the UK seeks to negotiate such bilateral deals with the EU and other countries. It is uncertain at present what stance the EU will treat on things like tariffs and import duties. Other possible outcomes include a Norwegian model of the UK joining the European Economic Area and a World Trade Organisation model relying on rights and obligations under the WTO rules. Replicating the EU's arrangements with Norway or Switzerland (which is part of European Free Trade Association) would require the UK to comply with many present and future EU regulations and continuing to allow the free movement of people, and Brexit campaigners have consistently said that this would be an unacceptable outcome .

What will happen to existing EU related laws in the UK?

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 actual Brexit, unless replicated or preserved by new legislation here (which in many cases would be a likely outcome at least as a stop-gap until tailored legislation could be put in place). 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. Simply allowing all UK domestic law derived from the EU to lapse, or revoking it, would be unworkable in the short term.

In much of the financial services space, the UK had comprehensive regulation in advance of implementing the numerous EU driven initiatives and, in numerous instances, kept gold plating. Known for providing a prudent regulatory environment, that approach is unlikely to change – and indeed should not be expected to change given that the UK regulators would still be expected to take a lead within the wider global regulatory environment – within the IOSCO framework etc.

Is the UK government likely to introduce legislation to address the risk?

We think it highly likely that the UK government will introduce some form of overarching legislation to address the fundamental legal uncertainties caused by Brexit. An obvious parallel (ironically) is the position at the time the UK was considering adopting the euro where it seemed likely that legislation would be required to avoid any doubts about the continuity of contracts notwithstanding a change of currency.

How will trade organisations in the financial sector such as the Loan Market Association and the International Swaps and Derivatives Association respond?

We cannot speak for the LMA, ISDA or any other industry association, but think it inevitable that they will take a part in addressing the consequences of Brexit and in particular on the effect it will have on new and existing documentation. It is, however, likely to take some time for documentation and practice to settle in the light of Brexit. It is also possible that such bodies will consider that they have no remit to issue general guidance on Brexit. The LMA will not, for example, offer legal advice to the loan markets, and may confine itself to lobbying the government as to its response, and to addressing issues in its standard form of documents.

General issues affecting loan documentation

What effect will a wider or prolonged period of market volatility have?

There is no simple answer to this. The question is speculative and largely beyond the scope of this note. It has been suggested that it seems reasonable to expect a period of volatility in financial markets, with possible increases in interest rates, increased costs for non-UK lenders in funding in sterling, and a reluctance to lend to UK businesses in currencies other than sterling. FX rates may be volatile, changing the mark-to-market value of transactions. Companies with a financial year (or half-year) ending on 30 June may have to test their financial covenants at that point, however many borrowers use an average exchange rate over the relevant period, which should smooth out immediate FX fluctuations.

There may though be some immediate issues. For example, we have been providing urgent advice to investment fund managers who need to plan ahead in case of an immediate period of market volatility means that it is impossible to ensure fair pricing of a fund, and so there may be exceptional circumstances which trigger suspension of dealing in units of the fund.

What effect will a Brexit vote have on existing loan documentation?

The Brexit vote will be followed by a period of negotiation. It is unlikely that existing loan documentation will automatically terminate or that the parties will have contractual rights to terminate it, unless such rights have been expressly negotiated, certainly in the period up to actual Brexit. It has, however, been relatively uncommon in the run-up to Brexit to include "Brexit terms": i.e. terms dealing specifically with the consequences of a vote for Brexit. Following Brexit, a party may be in a stronger position to claim that a contract has been frustrated (i.e. that performance has become impossible for reasons beyond that party's control), but this seems relatively unlikely to be successful in the case of loan and security documentation, and will be subject to any general legislation that might be introduced to preserve existing contracts. A contract heavily dependent on EU legislation could in theory be frustrated by Brexit, or a force majeure term might be triggered, particularly for a contract heavily dependent on the ongoing operation of particular EU legislation, but such a claim would be difficult in the absence of issues such as the loss of passport rights (see further point 20 below).

How will governing law be affected?

English law facility documentation almost invariably contains an express choice of law provision. The current EU rules on governing law are set out in Rome I and II Regulations. The UK may choose to leave the substance of these rules in place, but under the supervision of the UK courts. Alternatively it may 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.

How will jurisdiction be affected?

The facility documents will also usually contain a submission to jurisdiction, typically 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 should have appointed a process agent in England for service of legal proceedings.

The Recast Brussels Regulation 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 jurisdiction, or where assets such as real estate are the subject matter of the contract.

On Brexit, the UK will 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 are still likely to uphold an English choice of law provision, but how the courts of other Member States will regard such provisions is a matter for their own laws, and may give rise to uncertainty.

If the UK does not accede to the Lugano Convention, there would be no bar to parallel proceedings, provided the courts in other jurisdictions are 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 accedes to the Lugano Convention on Brexit, which contains similar rules, the leave of the English courts may become necessary in order to serve proceedings in the EU.

How will enforcement of judgements be affected?

The recognition and enforcement of judgments within the EU is provided for in the Brussels Regulation. Without that, and unless the UK accedes to the Lugano Convention, the enforceability of judgments of the English courts elsewhere in the EU will depend on the laws of each Member State. This may increase the attractions of a provision for arbitration of disputes under the facility documents, using the enforcement mechanisms under the New York Convention.

Will the substance of English law be affected?

It is uncertain how far the UK government will decide to leave existing EU law in place as part of English law on 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, a measure to ensure substantial continuity post-Brexit seems inevitable. If the UK opts for EEA membership, present and future EU legislation falling within the scope of the EEA Agreement will apply to the UK.

Will references to EU law in the documentation continue to work?

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 scope for uncertainty and a need to review documentation with this issue in mind.

Specific Facility Documentation issues

Will the same answers apply to every facility document?

There is a reasonable degree of consistency across documentation in the commercial loan markets, particularly in the case of "boilerplate" provisions[1], but of course documentation varies and must be reviewed in each case before advice can be given. Additional considerations may be relevant to retail lending, such as the principle of "treating the customer fairly" as may similar consumer related practices, rules and guidance.

How will references in the documentation to EU law work post Brexit?

Given that a period of negotiation with the EU of at least two years is required before Brexit, there is a window for review and potential renegotiation between parties to existing finance documents. The vote for Brexit is, however, likely to have a more immediate effect on the negotiation of new finance documentation, although detailed consideration will be required to determine when it is necessary to amend provisions dependent upon or derived from EU laws which remain in place, for the time being, or may be preserved or replicated on Brexit.

Will definitions and interpretation provisions work?

References to EU Regulations and Directives no longer in force in England will need to be replaced in due course. A 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". Subject to some sort of statutory measure to continue EU laws, many references to EU laws, such as to the "centre of main interests" (COMI) under the Regulation on Insolvency Proceedings, will presumably either continue to operate or will fall away as meaningless.

[1] Boilerplate clauses are those which are not specific to a particular transaction (generally having nothing to do with the commercial terms), and are typical for commercial agreements.

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.

Can the facility still be utilised?

Short of the facility agreement being frustrated (which seems unlikely) Brexit will only affect the ability to draw or roll over advances if it constitutes or triggers an event of default (or possibly potential event of default), or if repeating representations become untrue.

How will optional currency provisions work?

There seems no obvious reason why Brexit should affect the optional currency provisions of a facility agreement.

Will prepayment and cancellation provisions be triggered?

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 licences or authorisations to perform their obligations and to continue as lenders. Financial institutions whose home state regulator is in the UK will have to revisit how they ensure the proper licences and authorisations are in place for any business originated out of branches in EU member states operating under a passport. If it ultimately became illegal for a lender to continue its activities this would be likely to trigger a repayment obligation or, depending on the terms of the documents or as a result of negotiation, a shift of lending office or transfer of the loan to another lender. 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, Brexit seems unlikely in itself to trigger prepayment obligations.

Borrowers may seek to negotiate prepayment rights linked to Brexit, but this seems a largely commercial rather than legal issue.

Depending on the documentation, many borrowers will often have a right of prepayment of single lenders invoking tax gross-up provisions, tax indemnity or increased costs provisions.

Will interest provisions continue to operate?

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

Will market disruption clauses be triggered?

The drafting of such provisions varies, but a lender whose costs of funds is in excess of LIBOR usually has 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 difficult to say whether such provisions may be engaged and whether market-standard provisions will be heavily negotiated. The Eurozone crisis saw a number of lenders considering whether they could invoke increased costs clauses in view of their difficulties in obtaining funds in the interbank markets.

Will tax gross up and indemnities be triggered?

The tax impact of Brexit will depend on a number of factors, including the nature of the UK's future relationship with the EU. Brexit will 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 will be adversely affected, or that the relevant provisions require amendment. But in due course, Brexit will probably mean that the European Directives providing exemption from withholding tax on intra-group interest payments will cease to apply to UK companies, which could impact UK headquartered groups. Loans form lenders or bondholders should not be affected, save that loans to Italian borrowers will become subject to withholding tax at the point the UK leaves the EU.

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. Brexit will not, therefore, cause the UK legislation implementing the VAT Directives to fall away automatically, and VAT will continue to apply in the UK, although there could be an impact on cross-border supplies.

In relation to trade finance, the EU Customs Duty Regulations will no longer apply to the UK on actual Brexit, leaving the UK without any customs duties, but the position will depend on what new arrangements were put in place.

Will increased costs and other indemnities apply?

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 may apply from arrangements put in place on Brexit, and it would appear unrealistic in most cases for borrowers to expect to exempt 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 Brexit because it can assess the impact it will have on it at this stage may be a difficult one.

Will representations and undertakings be breached?

Representations will require review for applicability in the light of Brexit. A representation such as that a borrower's COMI is and will remain in the UK may be analysed in a number of ways, and will ideally be amended or dispensed with. An argument that it is breached on Brexit seems unattractive.

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The practical effect on undertakings to comply with laws will 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 the UK will need to preserve EU-derived legislation in force, and that wholesale revisions to representations and undertakings is not 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 continue to apply. Seeking to require compliance with EU laws no longer applicable in the UK will 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.

Will there be an event of default?

Those most likely to be relevant (subject to any legislation to preserve existing contract rights and obligations) are probably misrepresentation, unlawfulness and material adverse change.

The wording of material adverse change events of default differ. Case law has slightly reduced the risks a lender runs in seeking to invoke an event of default 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 Brexit will probably be something of a last resort, although there may be situations where Brexit is 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.

How will payment mechanics provisions be affected?

It is difficult to say how payment mechanisms will be affected in the long term by Brexit. Although payment services are subject to EU legislation, it would be unduly alarmist to suggest that Brexit will cause issues for the interbank markets that will not be dealt with. It seems unlikely that Brexit will trigger a Disruption Event (a material disruption to payment or communications systems) under an LMA style facility agreement, or that any specific amendment to such provisions is appropriate.

How easily can the documentation be amended?

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 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 or a Brexit.

Should agency provisions be amended?

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

Should governing law and enforcement provisions be amended?

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 a choice of English governing law should remain appropriate and effective.
Depending on the arrangements put in place on 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 is therefore all the more important to require borrowers and security providers to appoint a process agent in England. That is of course already common practice.

What will be the effect on security documents?

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

In general security interests should not be prejudiced by Brexit, although clearly the value of the collateral could be affected. English law security creates a property right and this will remain intact regardless of Brexit, although matters such as cross-border insolvency and enforcement regimes deriving from EU laws should be reviewed. The lender's remedies under its security should be largely unaffected, although the right of appropriation of financial collateral derives ultimately from the Financial Collateral Directive and may be prejudiced by a repeal of the European Communities Act without some holding measure being put in place.

There is no reason to suppose that lenders' contractual rights under English law guarantees will be adversely affected. A guarantee may be released by many steps taken without the guarantor's consent, unless there is suitable protective wording, but Brexit is unlikely 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 is usually an indemnity provision for the lender to fall back on.

Swap Documentation issues

How will Swap documentation be affected?

Many of the considerations set out above with respect to loan documentation will apply equally to swap documentation, subject to well understood differences between the two types of documentation. 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 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, be 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.

EMIR will remain relevant as the UK will want to enact measures that are at least equivalent to EMIR, not least in order to ensure that UK clearing houses can become recognised third country central counterparties. The implications 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.

How will repo and stocklending documentation be affected?

Again similar considerations apply and, as before, there are unlikely to be any immediate consequences for standard repo and stock-lending master agreements. It remains to be seen whether the UK will want to transpose regulations such as SFTR and CSDR. Our guess is that the UK will want to do so, as these regulations are such an integral part of the European market for repo and stock-lending.

If you are interested in discussing any of the points above, please get in touch with your usual contact at Fieldfisher.

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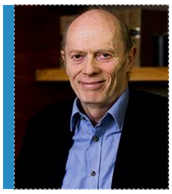

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