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Skadden

Brexit

On June 23, the UK electorate took the historic decision to leave the European Union (EU), a process that has never been undertaken by any member state. While the vote itself does not trigger the process of exit from a legal perspective, it has already caused significant domestic political upheaval.

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The ultimate impact of the decision to exit, or even the precise route by which an exit would be effected, cannot be predicted with any degree of accuracy, but it is clear that a re-calibration of Britain's relationship with Europe may have far-reaching consequences for British businesses and those considering investing in Europe. This note has been prepared to provide a summary outline of the immediate and longer-term process for Britain's anticipated exit from the EU. We also set out certain areas of immediate interest: tax, anti-trust, state aid, disputes, data protection, employment, financial services and debt financing. We will be providing further analysis as various issues become clearer.

Immediate and Longer-Term Process

The UK has voted to leave the EU, but the status quo will be maintained for the immediate future

- The vote to leave the EU marks the start of a long, complicated and unprecedented process, the precise timing of which is not yet known.
- What we do know is that as a matter of European and domestic law, nothing fundamental will change for the United Kingdom or British companies unless and until the formal legal mechanism for an EU member state to withdraw from the union under Article 50 of the Treaty of Lisbon is invoked.
- Formal negotiations with the EU to agree the terms of Brexit will not commence until the UK serves notice under Article 50.
- As soon as the UK formally notifies the European Council of its intention to leave the union, a two-year time limit for negotiating and reaching a deal is triggered, although this period can be extended if the European Council and the UK agree to do so. The time required to re-negotiate Britain's relationship with the EU may take substantially longer than two years. In any case, the process is irreversible once notice has been served.

Implications for the EU and the global market

- The British decision has the potential to trigger a deeper existential question for the EU. Already in the Netherlands and Denmark similar referenda are being mooted – there is a potential for a 'fraying at the edges' of the union and/or a pulling together among the core member states.

Prime Minister David Cameron has announced his intention to step down, triggering a Conservative Party leadership contest

- In his formal statement on Friday, June 24, Prime Minister David Cameron announced his intention to step down, but confirmed that he would remain in office until his successor is appointed.
- Mr Cameron's decision to resign triggers a Conservative Party leadership race that could take several months to play out and may lead to an early general election.

The formal exit clause under the Treaty of the European Union will not be triggered for some months

- Mr Cameron has made clear that the decision on when to trigger the Article 50 exit clause is one for his successor. This means the decision will not be taken immediately and, as such, no formal negotiations with the EU are expected to take place until this autumn at the earliest.
- The UK government will be engaging in informal discussions both within Parliament and with the other members of the EU in the meantime.
- Based on statements by several members of the Conservative Party, it appears that the Article 50 exit clause may only be exercised once Britain understands the likely structure of its future relationship with the EU. This creates the prospect of the UK government seeking to delay delivery of an exit notice and negotiate the terms of exit (or an alternative) over a longer period of time, mindful of the next general election scheduled for 2020 (although the European Commission has said that no negotiations will take place prior to formal notification).

Ensuring stability of the UK economy

- Ensuring the stability of the UK economy will also be a key priority for the government over the coming days, weeks and months.
- Mark Carney, Governor of the Bank of England, has confirmed that the Bank is prepared to provide £250 billion of additional funds to support the functioning of the market and provide substantial liquidity in foreign currency.
- The union of the UK will be tested by Brexit in the coming months. Nicola Sturgeon, First Minister of Scotland, has stated that she will consider initiating a second referendum on Scottish independence.

Looking further ahead

- There are a number of potential Brexit scenarios, based on some current models:
  - If there is no agreement reached with the EU on a new relationship, the default position would be that the UK would essentially be in a "World Trade Organisation" position, with trade being conducted on a minimum WTO basis.
  - If agreement is reached, it is thought this would likely be in line with one of two principal alternatives:
    - the "Norwegian" alternative, under which, through European Economic Area (EEA) membership, the UK would have access to the single market. However, the UK would have to implement EU laws relating to the single market, without any say in how the rules are set; and
    - the "Canadian" or "Swiss" model – essentially a "bilateral" path, negotiating a series of agreements with the EU, sector by sector, in order to obtain access to the European market. The Swiss relationship is through membership in the European Free Trade Association, supplemented by some 120 separate bilateral agreements. The Canadian relationship is comprised in the Comprehensive Economic Trade Agreement, which took seven years to negotiate and is expected to be ratified in Europe in 2017.

  As both Norway and Switzerland are within the Schengen area, both models include the principle of the free movement of EU citizens and workers. Adopting the "Norwegian" model or the "Swiss" model may therefore require agreement to this principle. It is noteworthy that, in February 2014, Switzerland held a referendum on whether to limit the freedom of movement of foreign citizens to Switzerland. The proposed "quota" system has not yet been implemented and has faced significant opposition from the EU.
- Either way, given the extent of interaction that the UK has and has had with the EU, the UK is expected to continue to be subject to many EU rules, in particular in financial services.
- There is a mix of EU Directives (separately implemented by each country's parliament) that have been implemented into English law, and EU Regulations (which have direct legal effect in each country) that have not (a significant proportion of which supplement the nationally implemented Directives). There will thus be a significant amount of current EU law that will need to be reviewed and possibly replaced by English law. If there is any time period between exiting the EU and implementing domestic laws to cover areas previously subject to directly effective EU law, there may be uncertainty as to what system of law applies in certain situations.

Particular Areas to Note

Tax

- A variety of taxation changes could occur post-Brexit. As with so many other areas, much depends on the nature of the new UK-EU relationship upon conclusion of the Article 50 process.
- Equally, it is difficult to conclude whether the tax changes would be net beneficial for a UK-based business. What is certain is the uncertainty: it would be harder during the Article 50 process to know which sets of tax rules might apply at the end of that process, and many companies may have to operate parallel forecasting of two or more sets of tax rules during the pre-exit period.
- Below are some examples of what could change post-Brexit:
  - The requirement to implement certain EU taxation rules will be removed, most prominently, the requirement to implement EU VAT rules (VAT is a turnover tax and as such, within the competency of the EU). That said, much of the EU VAT legislation has already been incorporated into UK law and so there is arguably no constitutional issue with those rules remaining post-Brexit. Given the system already works fairly well, we predict little immediate impetus to move to a different system, even if rates might be adjusted. The clear point is that the UK is unlikely to be within the EU VAT system and so the UK will have to consider the impact of such rules when dealing with EU customers, and specifically the issue of reverse charges on intra-business supplies. This will naturally depend on negotiations with the EU.
  - While direct tax — strictly speaking — is outside the competencies of the EU, the impact of EU rules on UK taxation has historically been significant. This is driven by the fundamental freedoms that EU member states are bound to observe — particularly the freedoms of movement of capital, people and services. One of the derivative freedoms is the freedom of establishment of business. The European Court of Justice (ECJ) has interpreted and ruled unlawful certain UK tax rules that are in contravention of those freedoms, and the UK has had to adjust accordingly. That ruling power is likely to disappear.
  - Certain EU Directives such as the Parent-Subsidiary Directive and the Interest and Royalties Directive seek to remove withholding taxes intra-EU. The UK would not be bound by those going forward, but more importantly, other EU member states would no longer need to exempt payments to UK entities from their domestic withholding regimes on the basis of those Directives. Bilateral tax treaties are generally unaffected but do not always deliver the same outcomes.
  - Increasingly, the EU has looked to legislate rules that its members must implement in the sphere of anti-avoidance, most notably the recently proposed Anti Tax Avoidance Directive (ATAD), the text of which was preliminarily agreed upon in June. One effect of the ATAD is to gold-plate and even extend certain of the Organisation for Economic Co-operation and Development's (OECD's) anti-Base Erosion and Profit Sharing recommendations, applying a compulsory standard of implementation across the EU member states. Freed from such a Directive, the UK could choose its own path on anti-avoidance (*e.g.*, it may not want to implement the proposed general anti-abuse rule). As a result of Brexit, the UK may therefore have some additional flexibility in setting tax policy.
  - Recent domestic and European case law has concluded that stamp duty reserve tax and stamp duty levied in certain circumstances can breach the EU Directive concerning the prohibition on levying certain capital duties. If the UK is no longer bound by that Directive, the additional 1.5% cost of issuing or transferring shares of English companies into clearing or depositary systems (*e.g.,* DTC) as part of capital raises could make an unwelcome return. Notably, a similar transaction tax (the EU Financial Transactions Tax) has been proposed for implementation by certain EU member states, albeit on a basis that would affect non-member states as well as member states not in the relevant implementing group. The likelihood of this measure is currently low, but if it is passed, its impact on the UK as a non-member state may be weakened.
  - Absent re-negotiation of customs unions and trade agreements, one of the biggest tax impacts for most businesses selling goods into or through the UK and the EU will be customs/import duties, as these are largely set at a European level. Some argue that the impact will be offset by a weaker sterling.
  - The current UK government's commitment to driving corporation tax rates to the lowest in the G20 (17% from April 2020) may need to be revisited if projections on corporation tax revenue decrease significantly over the next few years, whether as a result of a reduced number of businesses being present or establishing themselves in the UK, a recession, stagflation, or persistent significant currency devaluation. Such a change in policy would clearly affect planning by multinationals.[1]

[1] The proposed EU-US Transatlantic Trade and Investment Partnership ("TTIP") has not been treated here as it is currently conjecture whether or not it will be passed; and in the absence of knowing the final version, it is not clear whether it would be beneficial for the UK to be outside or inside of that treaty, from a tax perspective. Certain tax-related topics are within scope, potentially, for TTIP, including the applicability of EU state aid rules to US Multinational Businesses.

Anti-trust

- The EU at present has (subject to limited exceptions) sole jurisdiction over most large M&A deals. Following Brexit, the UK aspects of such deals would no longer fall under the EU's jurisdiction, but rather under the jurisdiction of the UK's Competition and Markets Authority (CMA). This could lead to diverging timetables, procedures and outcomes. Business practices and conduct that affect trade between EU member states will still fall under the remit of the European Commission, but any aspects of such conduct that affect the UK would fall under the jurisdiction of the CMA. The same practices could therefore be subject to simultaneous and parallel investigations by the EU and CMA, with the attendant risks of differing processes, procedures and outcomes. More broadly, the CMA will no longer participate in the European Competition Network (ECN) post-Brexit (unless "observer" or other status is granted to it). Generally speaking, the CMA has been an advocate of sound and economics-based enforcement within the ECN, and its departure could therefore chill the "modernising" agenda within the ECN.

State Aid

- The EU has strict rules that prevent member states from granting financial or other aid to businesses, unless the aid has been approved in advance by the European Commission.
- The EU rules on state aid will no longer apply to the UK following Brexit (the application of such rules to allegedly favourable tax deals struck between EU member states and large corporations has been very topical of late). However, it is likely that the EU would request some type of agreement to ensure a "level playing field" on state aid, as part of a post-Brexit free trade agreement with the UK.

Disputes

- It is unlikely that Brexit will substantially affect the efficacy of English disputes clauses; consequently, it is unlikely that the UK's position as a leading forum for dispute resolution will be affected. Clients who have chosen to give jurisdiction over any disputes to the UK Courts should, however, be aware of certain legislative changes that may affect the enforcement of UK judgments in Europe in the short term:
  - Brexit will mean that key EU Regulations and Conventions (particularly the Recast Brussels Regulation and the 2007 Lugano Conventions), which regulate jurisdiction and the enforcement of judgments, will no longer apply to the UK.
  - While it is uncertain how the UK will deal with this change, there are a range of legislative options that could position litigants very similarly to the Recast Brussels Regulation. These options include (i) the UK signing the 2007 Lugano Convention on Jurisdiction and Judgments (in its own capacity), (ii) the UK signing the 2005 Hague Convention on Choice of Court Agreements (in its own capacity), or (iii) the UK signing individual bilateral agreements for mutual recognition and enforcement with individual EU member states.
  - Even if the UK were not able to accede to these various conventions and treaties, it would not mean that UK judgments would, overnight, become capable of recognition and enforcement only in the UK. Domestic rules of law within the EU member states ordinarily incorporate a principle of international comity under which a friendly jurisdiction will recognise and enforce the judgment of the courts of another friendly jurisdiction.
  - Brexit should not affect the conduct of English-seat arbitrations; consequently, London's position as one of the leading arbitral centres should not be affected. The procedural conduct of English-seat arbitrations is governed largely by purely domestic English law (the English Arbitration Act 1996) and the enforcement of English arbitration awards internationally is subject to the 1958 New York Convention, an instrument of international law signed by the UK in its own capacity rather than as a member of the EU. Arbitration awards made in English-seat proceedings will therefore continue to be enforceable within EU member states by virtue of the non-EU law derived New York Convention.
  - There may well be a shift in favour of the greater certainty offered by arbitration, which clients may wish to consider.
  - Rome Regulation I and Rome Regulation II, the current EU legislation that determines which law applies to contractual and non-contractual obligations in disputes before the UK Courts, would no longer apply in the UK post-Brexit. However, a number of options, including reverting to the common law position, would mean that the effect of the disapplication would unlikely be substantial. In these circumstances, both UK and EU Courts are likely to continue to uphold agreements on governing law and apply similar conflicts-of-laws rules to determine which law should be the governing law where the parties have not made an express choice.

Data Protection

- The Brexit vote comes at a critical juncture in the evolution of EU data protection law. US and EU representatives are currently finalising the "Privacy Shield", which will facilitate data transfers from the EU to the US, and last month the EU finalised a new and more robust General Data Protection Regulation (GDPR) that will take effect in 2018. It remains to be seen whether the UK will adhere to these proposed frame-

works or create a parallel structure. The UK's data protection regulator, the Information Commissioner's Office, has already stressed the need for "international consistency" going forward.

- Given the timing of the exit, in the immediate term, the UK will be required to adhere to the Privacy Shield, and – at least for a few months in 2018 – the GDPR.
- Longer term, since the UK has taken a more business-friendly approach to privacy, it may be inclined to craft separate privacy laws that are nonetheless deemed "adequate" by the EU, thereby following the approach taken by Canada and Australia.

Employment/Labour

- The UK vote to leave the EU is unlikely to result in immediate or major changes to core employment laws in the UK. The reasons for this are as follows:
  - Following a notification by the UK of its intention to exit the EU, there would likely be a lengthy negotiation period between the two. Given the uncertainty of the nature of the UK's relationship with the EU until these negotiations are concluded, it is unlikely changes would be implemented in this period.
  - Depending on the nature of the UK's relationship with the EU following an exit from the EU, the UK government may be required to retain EU employment law as part of any agreement with the EU. Alternatively, the UK may come under pressure from EU trade partners to maintain employment rights equivalent to those in the rest of the EU to ensure consistency.
  - It would be politically unattractive for the UK government to initiate a wholesale removal of a number of the UK employment laws originating from the EU that have now become workplace norms. Examples include the protection of fixed and part-time workers, some equality laws and protection for employees on business transfers (Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE)).
  - Certain UK employment laws actually exceed minimum EU requirements (*e.g.*, existing rights to maternity, paternity and parental leave and pay go significantly beyond what is required by EU law) or fall outside EU competence (unfair dismissal rights, whistleblowing) or were in place in the UK before being required by EU Directives (prohibitions on race, sex and disability discrimination).
- A far more likely outcome of Brexit would be that the UK employment law regime would remain largely as it is save that the UK government may legislate to remove or change some aspects of the existing laws that are unpopular with British employers. The main examples include: (i) the inability to harmonise employment terms after a business transfer under TUPE; (ii) various aspects of the working time rules, including record keeping and holiday pay (Working Time Regulations 1998, which give effect to the Working Time Directive); and (iii) the reinstatement of caps on certain compensatory awards that had been removed to comply with EU case law.
- A separate issue would be the end of the current automatic right for EU citizens to travel to, work in and have their qualifications automatically recognised in the UK (and for UK citizens to benefit from the same rights within the EU). Practically, this would form part of the negotiations for a new relationship with the EU, but if an agreement on this issue could not be reached, EU citizens may have to apply for permission to work in the UK under the current points-based immigration system, and UK citizens wanting to work in an EU member state would be subject to their respective immigration rules. This would add an administrative and financial burden to employers who currently move their employees around within the EU.

Financial Services Regulation

- Brexit raises issues on whether and how UK banks, insurers, broker-dealers, investment managers, investment exchanges and clearing houses can provide services to EU clients and access EU counterparties post-Brexit. Currently, UK financial services institutions access EU financial markets through EU single-market Directives and Regulations that provide a variety of "passporting rights" and automatic access to entities that are licensed or registered in an EU member state. Absent any agreement in respect of EEA status, these rights and access will disappear upon a UK exit from the EU once the Article 50 procedure is completed. In such circumstances, UK financial services institutions would effectively become non-EU "third country" entities. The same limits will apply to UK financial services institution subsidiaries of US and other non-EU companies. Many such companies rely upon their UK subsidiaries to provide services within the EU for which passport authority is required.
- Even absent any ongoing agreement as to EEA access post-Brexit, some UK financial services institutions may be able to continue operating in EU financial markets if:
  - the UK and the EU agree upon transitional arrangements allowing financial services institutions access to each other's markets on a "grandfathered" basis for a period of time; or
  - UK financial services institutions are able to make use of third country provisions that allow non-EU entities access to EU markets, provided that the UK is deemed by the EU to have "equivalent" regulatory rules and grants reciprocal access to EU entities. In insurance for example, where the UK has recently implemented the Solvency II regime, a grant of equivalence would be difficult to deny.

- However, it will likely take time to negotiate these arrangements. Therefore, we expect that some UK financial services institutions will look to adopt flexible approaches by conducting certain wholesale activities outside the EU, while simultaneously expanding their EU footprint. For example, some investment managers may expand their EU operations that will then delegate portfolio management, where practicable, to UK investment advisers. Equally, insurers currently operating from the UK may establish a carrier in another EU jurisdiction to provide flexibility, even if risk is subsequently reinsured back to the UK.
- These issues would fall away if the UK is able to become a member of the EEA by agreeing to implement EU laws, pay into the EU budget and concede the free movement of EU labour in the UK. In these circumstances, UK financial services institutions would be able to make use of passporting and automatic access rights.

Debt Financing — English Law Governed Loan Agreements

At this stage, in the absence of any clarity on how Brexit will be implemented, the areas on which clients should be focused are as follows:

- Most syndicated loan agreements contain a standard event of default triggered if an event or circumstance occurs which has, or could have, a material adverse effect (usually defined as, amongst other elements, an event or circumstance having a material adverse effect on the business, assets, financial condition or prospects of the relevant borrower or group).
- Although it is unusual for lenders to invoke MAE events of default, it is not unheard of for lenders to use them as a block to a new drawing. Even so we would not currently expect these provisions to cause issues for borrowers. However, currency and other general business volatility could have a serious impact on certain businesses so any MAE definitions (especially those including reference to "prospects") should be considered.
- Carve-outs from the negative undertakings and positive undertaking permissions are often partly regulated by reference to a basket amount denominated in the base currency of the facility. Significant changes in exchange rates can trip the covenant unless express provision is made to the contrary (assuming that the basket level was not exceeded at the time the group undertook the relevant transaction).
- With currency volatility there is obviously also potential for financial covenant issues where group income (in various currencies) is consolidated into a single currency for the purposes of financial reporting (and financial covenant testing).
- Multi-currency working capital facilities often require repayment if exchange rate movements cause the base currency amount of the facility to be exceeded. As such, the base currency amount of all drawings should be carefully monitored.
- Syndicated loan agreements contain provisions dealing with the setting of rates for EURIBOR or LIBOR if screen rates are not available (which may occur if there is considerable volatility in the interbank markets such that banks don't provide rates) – typically referred to as a Market Disruption Event. If such a Market Disruption Event occurs, EURIBOR or LIBOR rates are set by negotiation between the lenders and the borrower.
- As Brexit develops, further consideration will need to be given to the following standard provisions of Facility Agreements:
  - **Jurisdiction and Governing Law Provisions** – as discussed above.
  - **EU Bail-In Rules** – This may be relevant depending on whether the UK remains a member of the EEA on an exit from the EU.
  - **Centre of Main Interests (COMI) Representations** – For entities where their jurisdiction of incorporation is England and Wales (or Scotland or Northern Ireland), once the UK exits, such representations may need to be reconsidered.
  - **Illegality Provisions** – If EU passporting is withdrawn, it is possible that some banks may argue this trips the Illegality provisions in EUR denominated facilities as it restricts their ability to fund in Euro. Given the prominence of passporting in the Brexit debate, we think this issue will be fully addressed before Brexit occurs.