Client Update
Brexit—The Morning After

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Yesterday marked a tectonic movement in the UK's relationship with the European Union when almost 52% of voters voted 'leave' as their choice in a historic referendum.

The result of the vote has already led to market turmoil with the value of the pound dropping to its lowest level against the dollar since 1985 amidst early concerns that the financial sector was going to suffer a credit squeeze along the lines of the 2008 financial crisis and given the announcement that David Cameron will resign as Prime Minister. The mood is one of economic and political concern because the decision to leave marks the beginning of a period of unprecedented uncertainty both for clients based in the UK and those abroad who do business in the UK and in the EU.

Although the outcome of this referendum is not legally binding, the UK government has indicated that a vote for 'leave' marks the beginning of the process in which the UK will exercise its Article 50 rights of withdrawal under the Treaty on the European Union.[1] The UK will now need to negotiate a new agreement requiring the approval of 20 of the remaining 27 Member States representing 65% of the population of the EU. It has been suggested that the withdrawal and negotiation process with the EU of a new relationship can occur in tandem, but there is no guarantee that this will be the route chosen.[2]

The regulatory and legal implications of the decision to leave are significant, as EU and UK law have become increasingly intertwined over the last several decades.

[1] This is due to take place within two years after the UK formally notifies the European Council of its intention to leave. The Prime Minister has indicated that formal notification may not be provided immediately and will be triggered by the new Prime Minister of the UK. The two-year period can only be extended by the European Council, unanimously, in agreement with the Member State concerned (Article 50(3) TFEU).

[2] A joint statement issued today by the Presidents of each of the European Council, the European Parliament, the Council of the EU and the European Commission noted that it was expected that the UK government give effect to the decision of the people by triggering Article 50 as soon as possible.

The uncertainty surrounding withdrawal and its effects means that most businesses face a period of challenges. The New Settlement (and its accompanying changes for prudential regulation and carve-outs on freedom of movement) negotiated by the UK in early 2016 will no longer take effect. It is unclear whether the UK will seek to maintain its membership in the European Economic Area (the "EEA") as in the case of Norway, or whether it will choose to negotiate a bilateral agreement (either along the lines of Switzerland's European Free Trade Agreement or as a member of an EU Customs Union, as in the case of Turkey). It has also been suggested that the UK could choose to rely on the World Trade Organization (the "WTO") rules for trading access, although the UK's accession to the WTO appears to be on the basis of an agreement in which the Member States of the EU are obliged to act together. This calls into question whether the UK can rely on its WTO membership remaining unchanged upon leaving the EU.

The UK's historic vote to leave the EU will have a dramatic effect on the legal and regulatory landscape. While the path forward for the relationship between the UK and the EU remains unclear, one thing is certain: businesses should prepare to adapt to a fast-changing environment.

We discuss below the key legal and regulatory considerations for (i) financial services and regulation (ii) corporate transactions (iii) private equity (iv) dispute resolution and (v) tax.

FINANCIAL SERVICES AND REGULATION

Now that the UK has voted to leave the EU, it would be prudent for businesses to make contingency plans to prepare for potential changes to their ability to access the EU Single Market at the end of the withdrawal period.

At present, UK-based financial services providers are 'passported' once they have authorisation in one Member State; they need not obtain parallel authorisations in any other Member State in which they offer their services.

This principle of mutual recognition also applies in various other areas, such as the approval of prospectuses, the offering of shares or bonds to investors across the EU and the listing of shares on any EEA regulated market.

Under any new relationship less closely aligned with the EU single market, UK-based financial institutions and non-EEA businesses that are established in the UK may lose these advantages. Businesses that wish to continue to offer services in the EU should therefore carefully consider how these services could be provided following Brexit. UK insurers may be required to localise funds and report to the regulators of EU States in which they wish to operate, which may involve collateral requirements being imposed. It may be that the UK will seek third-country equivalence in relation to regimes such as Solvency II (the EU's new prudential regulatory regime which sets out rules to develop a single market for the insurance sector) in order to retain current advantages. Third-country equivalence is currently afforded to Switzerland and Bermuda.

It is also unclear what impact Brexit will have on EU and non-EU companies listed on the London Stock Exchange. Depending on the outcome of negotiations between the UK and the EU, it may be that companies will no longer be able to take advantage of the passporting regime available within Member States on the basis of their London Stock Exchange listings.

It has been predicted that financial regulation is less likely to be significantly affected because much of the UK's legislative framework will likely remain closely intertwined with EU regulation. A large proportion of EU legislation simply implements international obligations or guidelines by which the UK continues to be bound post-Brexit. It is possible that the UK may seek to repeal certain financial regulations but this will need to be balanced with potential impact on access to EU markets. It is possible that some less popular areas of EU regulation forming part of the current UK legal regime, such as the forthcoming Market Abuse Regulation[3], may be subject to reform following the UK's departure.

Businesses should, however, consult with their advisors on financial regulation risks at the earliest opportunity.

To discuss how to manage financial regulation risks, please contact Katherine Ashton, James Scoville, Vera Losonci, Ben Lyon or Tim McIver.

CORPORATE

Laws and regulations affecting M&A transactions are unlikely to be affected initially even post-withdrawal because the impact of EU-derived law and regulation in this area is relatively small. While the UK Takeover Code does give effect to the EU Takeovers Directive[4], the Code has also evolved independently

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[3] Regulation (EU) No 596/2014 on market abuse.

[4] Directive 2004/25/EC on takeover bids.

of the EU to take into account market conditions and the views of key market participants.

European law has made many more inroads on UK corporate law, including, but not limited to the Markets in Financial Instruments Directive ("MiFID"), the Solvency II Directive and the Prospectus Directive. Post-referendum, depending on the exit route chosen, there are likely to be substantial amendments to legislation based on these directives, particularly because it may be seen as desirable to create less stringent regulations to attract investments from non-European companies. This will, however, need to be balanced against the desire to maintain an ongoing relationship with the EU.

An additional wrinkle may arise under rules that impose or clarify nationality ownership requirements. Pursuant to EU policy on the free movement of capital, many of these rules impose national-ownership requirements that refer to ownership by EU nationals. These rules could change in a way such that companies that once met EU-nationality requirements no longer do so. Furthermore, if the UK ceases to be an EU member then UK nationals would no longer count toward nationality requirements by EU persons.

Competition law aspects

In summary, the fundamentals of competition law enforcement are unlikely to materially change as a consequence of Brexit regardless of what future relationship is negotiated. The UK has national legislation that runs in parallel to the existing EU rules and that will not change. Indeed, the UK has long been at the cutting edge of European competition law regulation and enforcement with measures in relation to (for example) follow-on litigation claims that are ahead of other Member States.

Similarly, in an M&A context, cross-border deals typically end up being reviewed and approved at an EU-level and that will not change. The main difference for M&A will be that whereas previously an EU clearance also covered the UK, in future there may be the need to have a parallel notification and review by the UK competition authorities at the same time as obtaining EU approval. Conversely, a deal that previously triggered an EU filing because of the parties' having significant UK turnover could now find itself subject only to review at a national level.

The implications of Brexit from a competition perspective are therefore likely to be longer term procedural and substantive ones if the UK diverges from EU jurisprudence, and a consequential increased cost for business of being subject to parallel regulatory regimes.

Companies involved in M&A transactions and other corporate transactions should carefully monitor the regulatory climate during the withdrawal period and seek advice on its implications.

Sanctions

The Brexit impact on the UK sanctions regime is currently difficult to assess. Many EU sanctions regimes reflect those implemented by the UN Security Council, which the UK is a member of, and so the UK will continue to enforce such regimes. However, the status of other, EU specific sanctions regimes, such as those relating to events in Ukraine, is more difficult to predict. Brexit is also likely to have consequences for the EU's approach to future sanctions regimes: in a recently published House of Commons Foreign Affairs Committee report[5] the Committee noted that the UK has been a driving force within the EU for implementing stronger sanctions, particularly against Russia, which may mean weaker EU regimes in the future.

To discuss how to manage corporate and M&A risks post Brexit, please contact Katherine Ashton, David Innes, Geoffrey Burgess, Raman Bet-Mansour, James Scoville or Tim Mclver.

PRIVATE EQUITY

Private equity sponsors and their portfolio companies will almost certainly be affected by yesterday's decision, although the shape of these effects will depend on the outcome of the negotiations between the UK and the EU.

A key pillar of those negotiations will likely concern the significant differences between the regime applicable to European and non-European fund managers under the European Alternative Investment Fund Managers Directive ("AIFMD"). Important issues to decide will include which regulatory regime UK-based fund managers will be subject to and what type of access UK-based fund managers will have in the EU market. The ability of a UK-based fund manager post-exit to be in a position to continue to use the AIFMD 'marketing passport', permitting the marketing of a fund to professional investors across Europe

[5] "Implications of the referendum on EU membership for the UK's role in the world", HC545, 26 April 2016.

without having to rely on national private placement regimes, will be of paramount importance.

Likewise, the day-to-day governance of private equity firms' portfolio companies should continue as usual pending the outcome of the negotiations between the UK and the EU. If the result of those negotiations is a loss of direct access to the internal EU market, businesses will need to adapt accordingly. Existing definitions in key portfolio company contracts referencing the EU, along with *force majeure* clauses, material adverse change clauses, and repayment events, are also likely to require re-examination once the UK's exit from the EU is mapped out.

It remains to be seen whether negotiations will result in the principle of 'mutual recognition' applying to UK companies. If it does not, the UK's exit from the EU may disrupt sponsors' ordinary course activities.

Private equity sponsors and portfolio companies should monitor these developments closely.

To discuss how to manage risks for private equity sponsors and portfolio companies, please contact Katherine Ashton, David Innes or Sally Gibson.

DISPUTE RESOLUTION

Various dispute resolution risks may arise for clients who use English-law governed agreements or who have opted for disputes to be resolved in the English courts.

Contractual Risks

Disputes may arise as to whether Brexit has the effect of triggering *force majeure* or material adverse change clauses in contracts, and particularly so in contracts dependent on free access to EU markets. Financial contracts based on industry standard forms, such as the ISDA Master Agreement and the Loan Market Association documentation, which include representations relating to the contracting parties' authorisation to transact under those contracts, may give rise to disputes on the proper interpretation of such clauses.

Businesses should review existing contracts, focussing on whether any supplemental amendments, including clarifications and carve-outs might be required, before disputes arise.

Enforcement Risks

The UK's exit from the EU is also likely to affect the enforcement of civil and commercial judgments obtained in the English courts and the reciprocal enforcement of European judgments in the UK. The current rules are set out in the Recast Brussels Regulation (EU 1215/2015) (the "Recast Brussels Regulation"). Under the Recast Brussels Regulation, Member State courts are compelled to recognise and enforce commercial judgments handed down by the courts of other Member States, negating the need to litigate in multiple jurisdictions. At the end of the withdrawal period, the Recast Brussels Regulation will no longer apply to the UK unless the UK accedes to it. Enforcement of UK court judgments in Europe and vice versa is likely to become less straightforward.

The UK may seek to accede to other international conventions. For example, the Lugano Convention 2007, which was entered into by the European Community (as it was then) on behalf of Member States, imposes a similar regime to the Recast Brussels Regulation and applies to EU Member States, Switzerland, Norway and Iceland (although it does not contain some of the refinements introduced by the Restated Brussels Regulation, for example allowing the court to give precedence to contractual agreements for exclusive jurisdiction). However, the UK would need consent to accede to the Lugano Convention. Another possibility is that the Hague Convention on Choice of Court Agreements 2005 would apply. This was entered into by the EU on behalf of Member States (excluding Denmark) and Mexico. It is anticipated that other States may also become contracting States in due course, increasing the importance of the Hague Convention. If the UK does not accede to either of these Conventions, the courts of Member States may still, however, elect to respect English jurisdiction clauses.

The English courts, with their reputation for fairness, predictability and impartiality, are likely to remain an attractive venue for resolving commercial disputes. Businesses should nonetheless carefully consider jurisdiction clauses specifying the jurisdiction of the English courts and whether additional enforcement risks may arise in light of the above. Businesses currently engaged in litigation that could lead to imminent enforcement risks may also wish to take advice on enforcement options and settlement opportunities before the arrangements for withdrawal from the EU are finalised.

Choice of Law

English law is unlikely to be affected as a choice of law in contracts, since it has long since been a popular choice of law governing international contracts, and has become standard in many markets. It was not significantly affected by EU legislation and is unlikely to change on the UK's decision to leave the EU. Businesses may wish to take advice on the consequences of choosing English law as the relevant choice of law if the choice of courts is not likely to be the English courts and if the current conflict of laws rules (Rome I[6] and Rome II[7] applicable to contractual and non-contractual obligations respectively) cease to apply to the UK.

Investment Treaty

Investors may be concerned about the impact of Brexit on the protection of their investments. EU Member States are party to approximately 1,400 bilateral investment treaties as well as numerous multilateral treaties.

Following the referendum, one key area that may change is Investor-State Dispute Settlement ("ISDS"). The purpose of ISDS is the encouragement of international investment and it has given investors the ability to enforce directly the investment protections given to them against States. Following the Lisbon Treaty, the competence for the protection of investments was transferred from EU Member States to the EU itself. This has given the EU a mandate and platform for the reform of traditional standards of international foreign investment protection. The EU has proposed a new approach on investment protection, with the creation of a court-like system with an appeal mechanism, based on clearly defined rules and proceedings before qualified judges. It is envisaged that this would replace the existing ISDS mechanism in TTIP and in future EU trade and investment negotiations.

The proposed approach has been criticised. Following implementation, the UK would not be bound by any of these treaties, and would be able to negotiate freely with States to implement trade agreements. However, negotiating such treaties is likely to take time, and it is not clear what will happen to foreign investments until any such treaties are negotiated and come into force.

To discuss how to manage general contractual documentation and your disputes post-Brexit, please contact Lord Peter Goldsmith Q.C., Tony Dymond, Richard Lawton, Kevin Lloyd, Karolos Seeger, or Patrick Taylor.

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[6] Regulation (EC) No 593/2008 on the law applicable to contractual obligations.

[7] Regulation (EC) No 864/2007 on the law applicable to non-contractual obligations.

TAX

The tax implications of today's Brexit are, as with many areas, uncertain and far-reaching and apply to those areas where the EU directly influences UK tax or the tax treatment of cross-border transactions within the EU and potentially to those areas where the impact has been more subtle.

VAT is an EU-wide tax drafted at an EU level with very little discretion granted to Member States. Leaving the EU means that the UK is free to determine how it charges VAT rather than working within rigidly defined parameters. In our view, it is unlikely that there will be dramatic changes to the VAT system and the most significant impact will be for those making or receiving EU supplies for whom the administrative and cash flow burden is likely to be increased. Further, we assume that leaving the EU will encompass leaving the customs union, meaning that EU imports to the UK could become subject to customs duties. Similarly, UK exports to the EU may become subject to customs or other duties.

To mitigate tax obstacles on payments within a group of EU companies, there are currently EU Directives ensuring that intra-group dividends, interest and royalties may move free of withholding taxes. Given the popularity of UK holding company structures, this is a potentially significant issue. Although the UK has an extensive double-tax treaty network and an income tax treaty with each EU Member State, not all treaties provide for a 0% withholding tax rate in the situations covered by the EU Directives. Any group having arrangements in place whereby a UK entity makes or receives dividends, interest or royalties from an EU group member will need to review its position.

Other potential consequences include that if the UK is no longer subject to the EU State Aid rules, then it would be free to agree more favourable tax treatment for certain businesses or sectors of the economy.

There are also less direct ways that the UK tax system may change.

UK tax laws have been subject to the overriding fundamental freedoms of the EU. This means that, over the years, UK tax policy has been shaped by the framework of the EU treaty principles (*e.g.,* the prohibition of state aid) and certain UK tax rules have been challenged in the UK or in the Court of Justice of the European Union (the "CJEU") on the grounds of fundamental freedoms. Where the CJEU has found against the UK, the UK has had to change its tax rules to satisfy the EU's requirements. Notably, this has led to reluctant changes in the way that the controlled foreign company regime works and also the decision not to apply a penal 1.5% stamp duty rate on UK shares that are issued into a clearing system. Whether the UK will endeavour to undo these taxpayer-friendly changes remains to be seen.

The final tax implication to note does not concern the UK itself but relates to the EU and its members. The Commission has recently revived its proposal to implement a common consolidated corporate tax base which comprise a single set of corporate tax rules which apply across the entire EU (with the rates being selected by each country). The adoption of such policy requires unanimous approval from Member States. To date, the UK has been the most vocal in its objection to this proposal, and without the UK's opposition, it will be interesting to see if the proposal gains more momentum.

To discuss the potential tax implications of Brexit, please contact Richard Ward, Matt Saronson, Cécile Beurrier or Ceinwen Rees.

CONCLUSION

After months of campaign bluster and fervent speculation, the results are in: the UK is saying goodbye to the EU. While the exact timing of its goodbye and legal and regulatory implications of yesterday's historic referendum are not yet clear, one thing is certain - significant changes to the UK's relationship with the EU are on the way. During this time of transition, it is crucial that businesses prepare for the potentially wide-ranging consequences of the UK's planned exit from the EU and position themselves to navigate the rapidly shifting legal and regulatory environment. We are closely monitoring developments and will be updating our clients with additional guidance as further information becomes available.

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Please do not hesitate to contact us with any questions.