Impact of Brexit on debt and equity financing transactions

Overview

On 23 June, the UK voted to leave the EU, the first step in a process that is likely to lead to the biggest demerger in history: the world’s fifth largest economy (the UK) leaving the world’s largest economic grouping (the EU).

The vote to leave has caused significant market volatility and there will be continuing uncertainty during the lengthy period in which post exit arrangements are negotiated.

While the impact of Brexit will not be fully understood until negotiations are complete, many businesses are analysing what Brexit might mean for them. One aspect of this contingency planning is to consider how Brexit may affect corporate finance transactions.

In this note, we examine some of the possible consequences of the vote to leave and Brexit itself for debt (whether via loans or bonds) and equity financing transactions governed by English law.

In large part, we conclude that there is little immediate impact on existing or new transactions. Contracts will continue to be enforceable and parties’ rights and obligations will be largely unaffected. Generally, specific Brexit-related contractual provisions are unlikely to be needed at this stage. However, disclosure reflecting the possible consequences of Brexit for particular businesses may be appropriate for some debt and equity capital markets transactions. We may see some changes to transaction documents over time, particularly as the exit arrangements take shape and it is sensible to keep the situation under review as events unfold.

This article is one of a series of specialist Allen & Overy papers on Brexit. To read these papers, please visit: www.allenovery.com/Brexit-Law.
Analysis

Brexit is not Grexit

When considering the potential impact of Brexit, it is important to bear in mind that, despite some of the political rhetoric and media commentary since the referendum vote, it will most likely be a carefully managed, orderly and consensual process. Most of the issues that Brexit raises are very different from those that arose in the context of the eurozone crisis. In the eurozone crisis, there was a real risk that a financially distressed member state might suddenly and unilaterally leave the eurozone, and possibly the EU in breach of EU treaties, or that the eurozone itself might collapse. In contrast, the UK is neither financially distressed nor part of the eurozone, and is very likely to leave the EU as part of a negotiated arrangement under Article 50 of the Treaty on European Union.

Having said that, there will, of course, be an extended period of uncertainty and financial market volatility during the period of the exit negotiations, and some businesses may be adversely affected by that uncertainty or volatility, or the economic consequences of Brexit itself. However, neither the vote to leave, nor Brexit itself raises concerns about sovereign insolvency, redenomination of debts, or the introduction of capital or exchange controls.

The short to medium term impact of the vote to leave on existing and new debt and equity finance transactions is likely to be limited from a legal perspective, although the associated uncertainty and volatility may lead some businesses to put transactions on hold for a period. In the longer term, the impact of Brexit itself is less clear. In part, it will depend on the exit arrangements and those arrangements will almost certainly specifically address some of the potential impacts. It is therefore difficult to predict outcomes with any confidence at this stage. Any regulatory changes could have significant consequences for debt and equity capital markets transactions (eg if the UK’s ability to access the single market for financial services is not preserved) and the attractiveness of the UK as a listing venue.

How will Brexit affect existing transactions?

Many transactions will mature before Brexit occurs

Among the many uncertainties around Brexit is how long it will take for the UK actually to leave the EU. It is likely to be a minimum of two years (which is the period that Article 50 provides for negotiation of exit arrangements once notice to leave has been served), but could be longer. As a result, many existing debt financing transactions will not be affected by Brexit itself because they will mature before it occurs. However, it is possible that existing transactions may be affected by the uncertainty and financial market volatility in the meantime.

Brexit is unlikely to frustrate or otherwise affect the enforceability of documents

It is unlikely that Brexit or events leading up to it will frustrate or affect the enforceability of English law governed documents.

For a contract to be frustrated under English law, performance must become illegal, impossible or require something radically different to what was originally agreed as a result of some unforeseen event outside the control of any party. Even in respect of transactions where Brexit was genuinely unforeseen at the time of the transaction, it would take an unusual set of circumstances for Brexit or events leading up to it to meet the other requirements for frustration.

It is also difficult to see how Brexit or events leading up to it could otherwise affect the enforceability of an English law governed document.

In any event, issues of contractual continuity may be addressed as part of the exit arrangements.

Brexit is unlikely to trigger standard prepayment or default provisions, or MACs by itself

Few, if any, existing debt financing transactions will specifically contemplate Brexit. It is, therefore, necessary to consider how the usual provisions of a loan or bond document would respond to Brexit and events leading up to it. Inevitably, much will depend on the specific circumstances and drafting.
In the context of lending transactions, it is unlikely that Brexit or events leading up to it would, by themselves, trigger any of the standard mandatory prepayment events or events of default.

Similarly, it is unlikely that Brexit or events leading up to it would, by themselves, trigger any of the events of default in standard bond terms and conditions or a standard force majeure clause in bond documents.

Although unlikely, it is possible that Brexit itself may trigger the standard illegality mandatory prepayment event in loan documents if the exit arrangements do not preserve the ability of the UK financial institutions to lend to EU borrowers without local authorisations where required. However, in practice, financial institutions may be able to avoid illegality by moving loans to affiliates and, in any event, the issue may be addressed in the exit arrangements.

In relation to material adverse change (MAC) events of default or other MAC related provisions in financing documents, for most borrowers or issuers the vote to leave itself is unlikely to have a direct material adverse effect on their business or financial condition, their ability to perform their obligations or the enforceability of the relevant documents. As a result, it is unlikely to trigger a typical “business MAC”.

However, Brexit itself or events leading up to it could potentially trigger “business MACs” for some borrowers or debt issuers (eg if their business relies on free movement of goods, capital or people and it becomes clear that Brexit will affect those freedoms). This is more likely where a MAC has a forward looking element (eg a reference to “prospects”).

Whether a MAC is triggered depends on the specific circumstances and drafting, and needs careful consideration on a case-by-case basis. One point to bear in mind in this regard is that the law relating to MAC provisions means that a party is unlikely to be able to rely on a MAC on the basis of circumstances it knows about when it enters into a transaction. This could be relevant in the context of Brexit given the long lead up to Brexit itself.

In the context of loans in the process of being syndicated, the vote to leave may result in market flex clauses being invoked to increase pricing in an effort to ensure successful syndication. Again, the specific drafting of the market flex will determine whether any pricing increase is permitted in the circumstances.

**Brexit may adversely affect some businesses and that may trigger defaults**

Brexit and events leading up to it may adversely affect some businesses. For example, they may be affected in the short term by the uncertainty and financial market volatility associated with the vote to leave. Or they may be affected in the longer term by the consequences of Brexit itself.

In the context of lending transactions, the usual provisions in a credit agreement (such as the financial covenants) would respond to a deterioration in a borrower’s creditworthiness because of Brexit or events leading up to it just as they would respond to a deterioration for any other reason.

In the context of bond issues, issuers may want to consider preparing for the consequences of a potential downgrade (and any impact on interest rate step-up provisions).

There may be additional considerations in relation to specific kinds of debt capital markets transactions – see our specialist papers on the impact of Brexit on securitisations and the UK covered bonds market, respectively.

**Brexit should not affect the substance of the parties’ rights and obligations although documents may need to be amended in due course**

Brexit itself should not have any significant impact on the rights and obligations of the parties to an existing transaction governed by English law. The content of the rights and obligations should remain the same. This is because, at least in the context of general commercial contracts, English contract law is largely unaffected by EU law. See our specialist paper on the impact of Brexit on governing law for a discussion of this issue.

Transaction documents may include specific provisions that will be affected by Brexit (eg references to the EU and EU legislation that will cease to be appropriate). Similarly, they may include provisions that need to be reviewed (eg tax provisions, increased costs provisions in loan documents and selling restrictions in bond documents). Any affected provisions may need to be
amended in due course if a transaction matures after Brexit occurs. However, it would be premature to amend the affected provisions until the exit arrangements are clear.

**Brexit should not affect the enforceability of the parties’ choice of law or courts, or the enforcement of judgments**

It is highly unlikely that the English courts would change their approach to upholding English governing law and jurisdiction clauses following Brexit. The courts of other EU member states would also continue to respect a choice of English law as the governing law of a contract after Brexit subject to the usual exceptions.

The position in relation to English jurisdiction clauses and recognition and enforcement of English judgments may be more complicated. However, broadly speaking, in most cases member state courts should continue to uphold English jurisdiction clauses and recognise and enforce English judgments albeit that enforcement may be more time consuming and costly. See our specialist papers on the impact of Brexit on governing law and jurisdiction clauses for a discussion of these issues.

For contracts where the parties have agreed that disputes are to be dealt with exclusively by way of arbitration, the impact of Brexit is likely to be even more limited. This is because the UK (as well as all the other EU member states) will, following Brexit, remain a party to the 1958 New York Convention which provides for respect for arbitration clauses and enforcement of arbitral awards in signatory countries.

**How will Brexit affect new transactions?**

**The points made about existing transactions apply equally to new transactions**

As with existing transactions, some new transactions will not be affected by Brexit itself because of the length of time it is likely to take for the UK to leave the EU although, as with existing transactions, some may be affected by the uncertainty and financial market volatility in the lead up to Brexit. Of course, the proportion of new transactions that may be affected will increase as Brexit approaches.

Most of the other points made above in relation to existing transactions will apply equally to new transactions once they have been entered into.

**Brexit may affect the timing and commercial terms of transactions**

Parties to new transactions need to consider how Brexit and events leading up to it might affect the transactions. Brexit-related events may impact on the timing and commercial terms of new transactions. Parties may defer transactions because of the current uncertainty and financial market volatility. This is likely to be particularly true for equity capital markets transactions.

For those debt financing transactions that go ahead, there may be reduced underwriting appetite, at least in the short term, and terms may be reviewed. In the context of lending transactions, tenors may be shorter (so that borrowers are forced to refinance before Brexit occurs), pricing may be increased, and covenants may be tighter.

For IPOs that go ahead, though, there is likely to be little impact – the “windows” during which listings are generally launched are limited, especially if the IPO involves an offering into the US (as many do). An issuer with a December year-end would typically be seeking to complete its IPO between March and mid-May of that year (based on audited annual results) or between September and mid-November of that year (based on audited interim results). Preparation for the marketing of new offers has resumed following the referendum and potential issuers are monitoring the market.

**The regulatory regime following Brexit remains subject to negotiation**

Depending on the form of the UK’s relationship with the EU following Brexit, it is possible that Brexit would result in the loss of the UK’s ability to participate in the mutual recognition regime between EEA countries which permits “passporting” of prospectuses. However, the European Commission already has the power to approve a non-EEA prospectus regime if it meets international standards which are equivalent to EU requirements, and so could
make a finding of "equivalence" with respect to any future UK prospectus regime.

Such equivalence would, in practice, be dictated by whether HM Treasury left in place the existing UK measures that are designed to replicate the European legislation creating the single market for financial services, including the EU Prospectus, Transparency and Market Abuse regimes. There may be moves to adapt legislation to address any concerns that it is overly burdensome on business.

Of arguably greater importance is the ability of those marketing an offering (i.e., the banks) to be able to passport their ability to market the securities throughout the EU and whether Brexit has a broader impact on the attractiveness of London as a listing or trading venue. The UK has deep pools of liquidity, a broad and diversified investor base, and a large research analyst and professional services community. Its attractiveness as a listing or trading venue will be driven primarily by these factors.

One question that is coming up in discussions about new transactions is whether contractual recognition of bail-in provisions should be included in English law governed documents for transactions that will mature after Brexit occurs. The concern is that if the UK ceases to be a member of the EEA, Article 55 of the Bank Resolution and Recovery Directive (BRRD) may require EEA financial institutions to include bail-in provisions in their English law governed documents. However, it is currently far from certain that this requirement will be triggered because it depends on the exit arrangements, and, in any event, there may be some form of grandfathering of liabilities which exist when Brexit occurs. Given that there is no current need to include bail-in provisions in English law governed documents and it may not be necessary when Brexit occurs, institutions subject to BRRD may conclude that it is premature to do so for now.

**Specific Brexit provisions are likely to be the exception rather than the rule**

It is possible that some new debt and equity financing transactions will specifically contemplate Brexit or that the impact of Brexit may be the subject of disclosure. Generally, Brexit-related contractual provisions do not seem to be a feature of current transactions, but, as noted below, it has become more common since the referendum vote to see Brexit related risk factors in bond prospectuses.

Lender requests for Brexit-related events of default or mandatory prepayment events in credit agreements are unlikely to be accepted by borrowers. Likewise, requests for Brexit-related termination rights in bond documentation will be difficult to negotiate. Indeed, given the nature of Brexit, it is difficult to see why they would be needed except in quite specific circumstances.

Similarly, borrower requests for specific Brexit carve-outs from standard events of default and mandatory prepayment events in credit agreements are unlikely to be accepted by lenders. For example, in the context of MAC events of default, if Brexit or related events have a material adverse effect on a borrower’s ability to perform its obligations, a lender will most likely want that to be a default. It is the effect rather than the cause that is important in the context of a MAC.

**Issuers should consider the appropriateness of including Brexit-related risk factors**

Brexit-related risk factor disclosure in prospectuses for bond issuers may be appropriate if an issuer’s business or a transaction structure is likely to be adversely affected by Brexit. It would also seem that risk factors flagging the market volatility implications of the vote to leave and its aftermath are becoming more common. At this stage, any such disclosure will necessarily be high level given the inherent uncertainties of how Brexit will play out, and its appropriateness will need to be carefully considered on a case-by-case basis. Additionally, if a Brexit-related risk factor is included by an issuer in its bond prospectus, the issuer should consider engaging with employees and investors at a more general level about the risk to its business.

The inclusion of Brexit-related risk factor disclosure wording is less likely to be required in relation to equity financing because of the ability to strategically time IPOs and secondary equity capital raisings.

See our specialist papers on the impact of Brexit on securitisations and the UK covered bonds market for discussion of the particular considerations in the context of such transactions.
Specific Brexit provisions need careful drafting

To the extent new transactions contemplate Brexit, the relevant provisions will need careful drafting to minimise the scope for disputes. For example, there may be questions around how to define Brexit and what the trigger for a provision should be. There are certainly no "standard" Brexit provisions.

Parties will also need to consider the impact of any Brexit-related provisions on connected contracts to ensure they do not inadvertently create mismatches (eg between a loan and any related hedging).

Any Brexit-related provisions will necessarily be somewhat speculative until the exit arrangements become clear. One issue for parties to bear in mind when considering Brexit-related provisions is the risk that any such provisions may inadvertently prove to be unhelpful once the exit arrangements are settled. For that reason, as a general rule, we recommend that parties are cautious about trying to anticipate Brexit in transaction documents for now.

There is no need for parties to change their approach to choice of law or courts

There is no reason for parties to new transactions to change their approach to governing law and jurisdiction clauses in the vast majority of cases. English law will remain a sensible choice for a variety of reasons (including certainty and familiarity) and both the English courts and those of EU member states will continue to respect that choice subject to the usual exceptions. It also seems likely that member state courts will continue to respect the choice of English jurisdiction and to recognise and enforce English judgments in the vast majority of cases although, as already noted, the position in relation to jurisdiction and judgments is more complicated. In relation to jurisdiction clauses, we may see an increased preference for exclusive jurisdiction clauses so that parties can obtain the benefit of the reciprocal regime for respecting exclusive jurisdiction clauses and related judgments under the Hague Convention on Choice of Court Agreements (which the UK may sign following Brexit). See our specialist papers on the impact of Brexit on governing law and jurisdiction clauses for a discussion of these issues.

What does this mean for you?

For the most part, Brexit and events leading up to it are unlikely, in themselves, to have a significant direct impact on the legal aspects of existing or new loan, bond or equity financing transactions governed by English law. Brexit itself should not affect the parties’ rights or obligations although some changes to documents may be required in due course. Specific Brexit provisions that attempt to address the eventual outcome of Brexit are likely to be unnecessary and unacceptable, and risk being counterproductive. However, bond issuers may wish to consider specific risk factor disclosure in prospectuses. Some parties may also have a preference for exclusive jurisdiction clauses.

Where Brexit and events leading up to it are more likely to have an impact is around the timing of new transactions and general business confidence to do transactions. In addition, uncertainty and financial market volatility may adversely affect some businesses. However, default provisions in loan and bond documents would respond in the usual way to a deterioration in a borrower’s or issuer’s creditworthiness because of Brexit-related events.
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