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Brexit – legal consequences for commercial parties

Impact of Brexit on debt and equity financing transactions

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Issue in focus

With the referendum on the UK's membership of the EU set to dominate headline space in the media for the coming months, the possibility of Brexit is firmly on the business agenda. It is difficult to predict with any degree of certainty how Brexit would affect business. Economic forecasts vary widely and it remains unclear what form the UK's relationship with the EU and other global trading partners would take after Brexit.

However, some 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 Brexit for existing and new debt financing (whether via loans or bonds) and equity financing transactions governed by English law.

In large part, we conclude that neither a vote in favour of Brexit, nor Brexit itself, is likely to have a significant direct impact on existing or new transactions. Contracts will remain in force and the parties' rights and obligations will be largely unaffected. Generally, specific Brexit related contractual provisions seem unlikely to be needed at this stage, although some businesses may need to consider whether Brexit-related prospectus disclosure is appropriate. It is, however, sensible to keep the situation under review.

This article is one of a series of specialist Allen & Overy papers on Brexit. To read these papers as they become available, please visit: www.allenovery.com/brexit.

Analysis

Brexit is not Grexit

When considering the potential impact of Brexit, it is important to bear in mind that it would almost certainly 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 it is unlikely to leave the EU unilaterally rather than as part of a negotiated arrangement.

There may be an extended period of uncertainty and financial market volatility if the UK votes to leave the EU, and businesses may be adversely affected by that uncertainty or volatility, or the economic consequences of Brexit if it follows. However, Brexit would not trigger concerns about sovereign insolvency, redenomination of debts, or the introduction of capital or exchange controls. As a result, the short to medium term impact of Brexit on existing and new transactions is likely to be limited from a legal perspective, although the associated uncertainty and volatility may lead some businesses to put activity on hold for a period. In the longer term, the impact of Brexit from a regulatory perspective is unclear, but any changes could have significant consequences for debt and equity capital markets transactions if the UK's ability to access the single market for financial services is not preserved.

How would Brexit affect existing transactions?

Many transactions would mature before Brexit occurs

Among the many uncertainties around Brexit is how long it would take for the UK actually to leave the EU if the outcome of the EU referendum is a vote to leave. It is likely to be a minimum of two years, and quite possibly considerably longer. As a result, many existing debt financing transactions would not be affected by Brexit itself because they will mature before Brexit occurs. That said, it is possible that some existing transactions may be affected by the uncertainty and financial market volatility in the lead up to a possible Brexit.

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

For those debt financing transactions that may be affected, it is unlikely that Brexit or events leading up to it would frustrate or affect the enforceability of the 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 assuming that Brexit was unforeseen at the time the parties entered into 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 hard to see how Brexit or events leading up to it could otherwise affect the enforceability of an English law governed contract.

In any event, it seems reasonable to expect that legislation regulating Brexit will address issues of contractual continuity, removing any frustration or enforceability risk.

Brexit is unlikely to trigger standard prepayment or default provisions or MACs

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 would 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 a mandatory prepayment event or an event of default. For example, Brexit itself is unlikely to trigger a standard illegality mandatory prepayment event, or an unlawfulness event of default except in unusual circumstances. Nor is it likely to trigger a misrepresentation event of default based on the unenforceability of a finance document because, as already noted, Brexit should not affect enforceability.

For similar reasons, 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 documentation.

In relation to material adverse change (**MAC**) events of default or other MAC related provisions in financing documents, for most borrowers or issuers Brexit 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.

In addition, 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. Depending on when a transaction was entered into, a financier may have been aware of the possibility of Brexit. It is also possible that legislation regulating Brexit will override MAC and other

termination provisions to the extent they might otherwise be triggered by Brexit.

Of course, 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 EU referendum. Or they may be affected in the longer term if Brexit occurs and they can no longer rely on free movement of goods, capital or people, or they can no longer passport a regulated business or an approved prospectus throughout the EU.

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 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 Specialist papers No 4 and 5 in our series of specialist papers on Brexit for a discussion of the considerations in relation to securitisations and covered bonds, respectively.

Brexit should not affect the substance of the parties' rights and obligations

Brexit 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 Specialist paper No 1 in our series of specialist papers on Brexit for a discussion of this issue.

Some contracts may include provisions that use territorial terms like the "European Union". As a result, questions may arise as to whether the parties intended those terms to continue to include the UK following Brexit. However, the normal rules of contractual interpretation would come in to play. They would require consideration of what a reasonable person with all the background knowledge available to the parties would understand the terms to mean bearing in mind the factual and commercial context. In practice, such terms are likely to be rare.

Brexit should not affect 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 English jurisdiction clauses following Brexit. However, Brexit does raise a number of issues in the context of cross-border transactions. First, whether the courts of other EU member states would continue to respect a choice of English law as the governing law of a contract. Secondly, whether they would continue to respect a choice of English courts to settle any disputes. And thirdly, whether they would continue to recognise and enforce English judgments.

Generally, these issues should not present a significant problem. Member state courts should continue to uphold English governing law and English jurisdiction clauses subject to the usual exceptions. The position in relation to recognition and enforcement of English judgments may be more complicated, but it seems likely that member state courts will continue to recognise and enforce English judgments made under exclusive English jurisdiction clauses. This is on the basis that the UK could sign up to the Hague Convention on Choice of Court Agreements (the **Hague Convention**) to which the EU is already a party. See Specialist papers No 1 and 2 in our series of specialist papers on Brexit 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 enforcement of arbitral awards in signatory countries.

How would Brexit affect new transactions?

The points made about existing transactions apply equally to new transactions

As with existing transactions, some new transactions would not be affected by Brexit itself because of how long 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 a possible Brexit. And, 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 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 of new transactions. For example, parties may wish to avoid the period immediately before and after the EU referendum because of the likely volatility in the financial markets. This may mean that some transactions are brought forward or postponed.

For IPOs, 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 U.S. (as many do). An issuer with a December year-end would typically be seeking to complete its IPO between March and mid-May 2016 (based on audited annual results) or between September and mid-November 2016 (based on audited interim results). Although the windows for businesses with other year-ends will vary, the date chosen for the referendum is unlikely to conflict with many issuers' plans. And marketing of new offerings planned for the latter half of 2016 could, of course, resume after the referendum with the benefit of certainty as to the outcome of the vote (although there will still be uncertainty as to what form Brexit will take or, indeed, whether ultimately it actually happens).

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 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 Prospectus, Transparency and Market Abuse Directives.

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 prospectus disclosure. However, it seems likely that they will be the exceptions rather than the rule. Brexit related provisions certainly do not seem to be a feature of current transactions, and we saw very few proposals for similar provisions in the run-up to the Scottish independence referendum in 2014.

Lender requests for Brexit 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 hard 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, if Brexit or related events do have a material adverse effect on a borrower's ability to perform its obligations, a lender will likely want that to be an event of default.

As noted above, a party may not be able to rely on a MAC provision on the basis of circumstances it knows about when it enters into a transaction. So, one point for financiers to consider is whether they wish expressly to preserve their ability to rely on a MAC in relation to Brexit despite being aware of the possibility of Brexit when entering into a transaction.

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. In the run up to the referendum some issuers may also want to flag the market volatility implications of the impending vote. 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, the inclusion of a risk factor may be interpreted as suggesting that an issuer is taking a negative stance on Brexit, and an issuer should consider engaging with employees and investors at a more general level if it considers Brexit to be a 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 Specialist papers No 4 and 5 in our series of specialist papers on Brexit for a discussion of the considerations in relation to securitisations and covered bonds, respectively.

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 whether the trigger for a provision should be a vote to leave the EU or some later event (and, if it is a vote to leave, what happens if the vote to leave leads to another round of negotiations with the EU and a further referendum). There are certainly no "standard" Brexit provisions.

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

An important risk for parties to bear in mind is that legislation regulating Brexit may override contractual provisions or, worse still, that contractual provisions may inadvertently override otherwise helpful legislation regulating Brexit. For that reason, as a general rule, we do not recommend parties try to anticipate Brexit in documents for now.

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

There seems little reason for parties to new transactions to change their approach to governing law and jurisdiction clauses. English law and English courts will remain sensible choices and both the English courts and those of EU member states should continue to respect those choices subject to the usual exceptions. English courts may even start issuing "anti suit" injunctions again against parties who breach exclusive English jurisdiction clauses. It also seems likely that member state courts will continue to recognise and enforce English judgments although, as already noted, the position in relation to judgments is more complicated. In relation to jurisdiction clauses, there may be an increased preference for exclusive jurisdiction clauses to get the benefit of the Hague Convention (on the assumption that the UK signs following Brexit). See Specialist papers No 1 and 2 in our series of specialist papers on Brexit 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 existing or new bank, bond or equity financing transactions governed by English law. Brexit should not affect the parties' rights or obligations. Equally, specific Brexit provisions are likely to be unnecessary and unacceptable, and risk being counterproductive. Possible exceptions to this are that lenders on new transactions may wish to consider preserving their ability to rely on the usual MAC provision in relation to Brexit despite being aware of the possibility of Brexit when entering into the transactions and that bond issuers may wish to consider specific risk factor disclosure in prospectuses. 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. Brexit and events leading up to it may also adversely affect some businesses. However, in the context of lending transactions, the usual provisions in a credit agreement would respond to a deterioration in a borrower's creditworthiness because of Brexit related events.

Your Allen & Overy contacts

Trevor Borthwick
Partner
Banking – London

Contact

Tel +44 (0)203 088 2522
trevor.borthwick@allenovery.com

David Campbell
Partner
Banking – London

Contact

Tel +44(0)203 088 4758
david.campbell@allenovery.com

Michael Green
PSL Counsel
Banking – London

Contact

Tel +44 (0)203 088 2451
michael.green@allenovery.com

James Roe
Partner
Corporate – London

Contact

Tel +44 (0)203 088 4637
james.roe@allenovery.com

Elizabeth Wall
PSL Counsel
Corporate – London

Contact

Tel +44(0)203 088 3075
elizabeth.wall@allenovery.com

Anne Kirkwood
Senior PSL
Corporate – London

Contact

Tel +44(0)203 088 2165
anne.kirkwood@allenovery.com

Matthew Hartley
Partner
ICM – General Securities Group

Contact

Tel +44 (0)203 088 2824
matthew.hartley@allenovery.com

Amanda Thomas
Partner
ICM

Contact

Tel +44(0)203 088 2821
amanda.thomas@allenovery.com

If you would like to discuss the issues raised in this paper in more detail, please contact your usual Allen & Overy contact.