Linklaters

Topical issues

Brexit: potential implications for loan agreements

On 23 June 2016 the UK will vote on whether it should remain a member of the European Union (EU) or leave the EU. A vote to leave would result in ending the UK's existing relations with the EU and putting in place a new framework for its future relationship with the EU. This article considers some of the potential implications of such a vote for loan agreements.

Vote to leave – immediate impact

The first question is whether a vote by the UK to leave the EU itself has any immediate consequences under a loan agreement. If, as is likely, the loan agreement does not include any provisions which specifically refer to the UK referendum, such as events of default or mandatory prepayment requirements, the answer is likely to be no.

The standard provisions of a LMA-based loan agreement are unlikely to give rise to any rights or obligations in the event of such a vote. For example, it is difficult to see the material adverse change event of default being triggered, as the vote to leave itself is unlikely to result in the requirements of a typically drafted material adverse change provision being satisfied. It is also unlikely to lead to any of the repeating representations being incorrect.

Withdrawal – timing and terms

The next consideration is how the loan agreement would be affected if and when the UK subsequently withdrew from the EU. Clarity on the timing and terms of withdrawal, and any transitional arrangements, is needed to analyse this accurately. The withdrawal process means such clarity is likely to be absent for some time, giving rise to uncertainty as to the actual implications for any loan agreement.

There is no fixed period within which the UK would be required to serve the notice which starts the process for withdrawal set out in Article 50 of the Treaty on European Union. Once the UK has delivered such an irrevocable notice of its intention to leave the EU, a two-year negotiation period to conclude a withdrawal agreement follows. That agreement must be approved by the European Parliament and a qualified majority of the European Council (the Council), excluding the UK.

The withdrawal agreement will set out the arrangements needed for withdrawal, including the steps needed to undo the many legal, political and other obligations between the EU, its institutions and the UK, and the framework required for the UK's future relationship with the EU. Where rights and obligations are being terminated, transitional arrangements may be required to avoid unnecessary disruption to existing arrangements.

Withdrawal takes effect on the earlier of the date of concluding the withdrawal agreement or the date two years after the initial notification to the Council, unless the Council and the UK agree an extension. It is therefore possible, at least in theory, that withdrawal could occur at the end of the two-year period without an agreement having been concluded.

The EU forms part of the European Economic Area (EEA), alongside the non-EU EEA member states Norway, Iceland and Liechtenstein. If the UK left the EU, it would therefore also leave the EEA, unless it developed a new relationship itself with the EU as a non-EU EEA member state.

Withdrawal – legal consequences

EU treaties, directives, directly effective decisions and regulations, and rulings of the Court of Justice of the EU would cease to apply to the UK upon its withdrawal from the EU, unless their effect was specifically preserved by UK national law.

Assuming that there would not be a desire or capacity to rewrite UK law from scratch, provisions derived from EU law would probably be retained and directly effective EU regulations deemed to continue, at least for a transitional period. For example, the UK law on financial collateral arrangements would be likely to remain as it is well embedded in UK law. It derives from an EU directive as implemented by UK legislation in 2003, with subsequent amendments in 2009 and 2011. If the UK were to leave the EU, future amendments of the UK law on financial collateral arrangements to remain in line with the EU law position may however be less likely.

However, it would still be necessary to ensure that these laws function properly in the new situation. For example, the meaning of legislation or rules referring to the EU may need to be clarified and powers given to EU institutions would need to be replaced by alternative arrangements.

Loan agreement – key provisions affected

The key provisions of a LMA-based loan agreement which may be affected by the UK's withdrawal from the EU are discussed below. Each of these will require analysis in light of the terms of any such withdrawal.

> **References to 'the European Union' or 'European Economic Area':** the reference to 'the European Union' in the definition of 'Participating Member State' could be interpreted without difficulty after a UK withdrawal from the EU as this definition only applies to any EU member state which has adopted the euro as its currency. Conversely, it may be unclear whether the reference to 'the European Union' in the definition of 'Permitted Joint Venture' includes the UK after it has withdrawn from the EU. The reference to 'the European Economic Area' in the definition of 'Cash Equivalent Investments' may raise the same uncertainty, but this definition also refers specifically to the UK and so makes clear the position in relation to the UK. Each reference to 'the European Union' or 'European Economic Area' in a loan agreement would require analysis as to how it should be interpreted after a UK withdrawal. The withdrawal arrangements would be likely to address general contractual interpretation of such references.

> **Representation – 'centre of main interests and establishments':** any representation by the obligors as to the situation of their centre of main interest will be by reference to EU Regulation No. 1346/2000 on insolvency proceedings. This regulation has direct effect in the UK and it will be necessary to check if its provisions will be deemed to continue in the event of a UK withdrawal from the EU. If not, this representation may require amendment to refer to any replacement UK law in relation to any UK obligors.

> **Increased costs clause – Basel 3/CRD4:** if the increased costs clause specifically addresses costs arising from Basel 3/CRD4, typically by way of express carve-in, it is likely to include a definition of 'CRD4' by reference to EU Regulation No. 575/2013 and EU Directive No. 2013/36. Given the extensive European consultation which has shaped these laws since the financial crisis and the understanding which banks have developed of what Basel 3/CRD4 costs will be, it would be expected that these laws would remain in place, but the UK position may deviate from that of the EU over time. If this were to change, the appropriate way to address such costs under the increased costs clause may need to be revisited.

> **VAT clause:** if the UK left the EU, the UK's VAT legislation, which is based on EU Directive No. 2006/112, would be likely to continue, at least initially, but the tie between this and the underlying EU law would cease. This could mean that aspects of the UK's VAT rules would be interpreted differently and would leave the UK free to amend or repeal the VAT rules as it wished. The VAT clause in LMA-based loan agreements is drafted to apply easily across the EU, and this may require amendment to reflect the UK domestic legislation after a UK exit from the EU.

> **Undertaking – auditor controls:** the selection of which auditor control provisions to include in a loan agreement, if any, typically depends on whether the EU legislation governing statutory audit processes applies to the borrower. This legislation is set out in EU Directive No. 2014/56, which EU member states are required to implement by 17 June 2016, and EU Regulation No. 537/2014, with the relevant prohibition on auditor clauses under this Regulation coming into effect on 17 June 2017. If this EU legislation applies, it is important to include auditor control provisions which do not allow potential for the lenders to restrict the borrower's choice of auditor as this could be unenforceable under the EU legislation. If the UK were to leave the EU, it is likely that this legislation would continue under UK law, given the proposals on auditor control provisions previously made by the UK Competition and Markets Authority. The UK position may, however, deviate from the EU position over time.

> **Payments clauses – TARGET2:** TARGET2 can be connected to by central banks of Eurozone countries and non-Eurozone countries for payments in euro. The UK's position in relation to TARGET2 is therefore unlikely to change, at least initially, if the UK leaves the EU.

> **Governing law clause:** the English courts are obliged by two EU Regulations (Rome 1 and Rome 2, in relation to contractual and non-contractual obligations respectively) to give effect to the parties' choice of law (subject to limited exceptions). If the UK were to leave the EU and this legislation (nor any equivalent) did not continue under UK law, the efficacy of the parties' choice of law would largely remain. The English courts would, under English common law, uphold the parties' choice in relation to contractual matters. Although the position in relation to non-contractual matters is largely untested, the English courts would also be likely to uphold the parties' choice. EU courts would continue to apply Rome 1 and Rome 2, and so would continue to recognise the parties' choice of English law.

> **Jurisdiction clause:** subject to limited exceptions, EU legislation gives effect to a clause in favour of the English courts by conferring jurisdiction on those courts and requiring any non-chosen EU court to decline jurisdiction to the extent the clause is exclusive.
This legislation is principally set out in EU Regulation No. 1215/2012, known as the Brussels 1 Recast.
If the UK were to leave the EU and the withdrawal negotiations resulted in none of this legislation continuing to apply to the UK, the English courts would, under English common law, accept jurisdiction on the basis of the parties' choice. However, the treatment of the clause in relation to any non-chosen EU court declining jurisdiction in favour of the English courts, as a third-party non-EU state, would be more complex, potentially depending on the application of the Brussels 1 Recast, the Lugano Convention 2007 or national law and so resulting in greater inconsistency. This may be off-set by more freedom for the English courts to protect their jurisdiction, principally by way of anti-suit injunction.

> **Judgments:** within the EU, enforcement of court judgments is facilitated by the Brussels 1 Recast. If the UK were to leave the EU and the withdrawal negotiations resulted in this legislation (nor any alternatives) not applying to UK judgments, English judgments would be enforceable in EU member states on the basis of the national law of the relevant member state. This will vary between jurisdictions and local advice would therefore be required in relation to the relevant loan agreement. Foreign judgments from EU member states would be enforceable in England pursuant to English common law.
This would be more cumbersome procedurally than under the current EU regime, but otherwise there would be little practical impact.

> **Arbitration clause:** the parties' choice of London seated arbitration and related matters under any such arbitration clause is likely to be unaffected by the UK leaving the EU as arbitration law is regulated by national law (the UK's Arbitration Act 1996) and non-EU international instruments (the New York Convention). An arbitral award made in the UK should be recognised and enforceable in EU member states, and vice versa, on this basis.

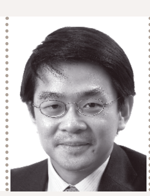
> **Bail-in clauses:** Article 55 of the EU Bank Recovery and Resolution Directive (BRRD) requires EU member states to ensure that EEA financial institutions incorporate contractual recognition of write-down and conversion language into most agreements creating non-EEA law governed liabilities. If the UK leaves the EU, the BRRD would be likely to continue to apply in the UK, at least initially, given how embedded it is in UK law. However, as the UK would no longer be part of the EEA, an English law governed loan agreement would constitute a non-EEA law governed liability. Such bail-in language, typically based on the wording produced by the LMA and LSTA, may therefore need to be included in loan agreements governed by English law.

Other issues may also impact a loan agreement and require consideration. For example, UK banks and branches may no longer benefit from EU passporting rights to do business throughout the EU. Clearing euro-denominated amounts in London may require analysis. Pan-European initiatives, for example in relation to developing a private placement market, may face more challenges.

This memo was first published in April 2016 by Practical Law as an article on www.practicallaw.com.

Key contacts

Kirsty Thomson
Partner, London
Tel: +44 20 7456 4465
kirsty.thomson@linklaters.com



Edward Chan
Partner, London
Tel: +44 20 7456 4320
edward.chan@linklaters.com

GC6780_F/04.16