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Brexit Briefing: Impact on Finance

Type: Legal Guide

Law Firm: Shearman & Sterling

Published: March 2017

Keywords: Brexit, Finance

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Brexit Briefing: Impact on Finance

Executive Summary

- Changes in foreign exchange rates since the Brexit vote and the general volatility of the foreign exchange markets may have an impact on your financing agreements
- Generally financing agreements are not likely to change in a material manner as a result of Brexit but certain technical changes will be required in due course
- Assess your exposure to currency fluctuations and review your financing agreements for the matters specified in our Checklist of Key Action Points

Overview

While the result of the Brexit vote itself does not have any legal force in the short term, it has triggered significant volatility in the financial markets resulting in significant currency fluctuations. Brexit itself may also affect your existing and future financing agreements. For the purpose of this article, we will use the term financing agreements to refer to loan agreements, overdraft facility agreements, letter of credit facility agreements, cash pooling agreements and any other agreements documenting a banking facility.

This article discusses:

- the impact of the Brexit vote on currency fluctuations;
- the impact of Brexit on financing agreements; and
- certain near-term practical steps you can take in relation to your financing agreements and any exposure you may have to currency fluctuations.

The considerations below in respect of financing agreements will be relevant whether you are a borrower or lender under a particular financing agreement.

The impact of Brexit on the availability of grants and other direct funding from the EU is not covered, as it is being addressed in separate A4ID publications.

Currency Fluctuations

Background: Both the change in foreign exchange rates since the Brexit vote and the general volatility of the foreign exchange markets may have an impact on your financing agreements.

Foreign exchange exposure can arise in a number of different circumstances including:

- when receiving donations or grants in a currency that is not the same as the currency of your costs; and
- in the context of micro-finance, borrowing amounts in a currency that is not the same as the currency in which you lend.

The terms of your existing financing agreements may also include provisions that were based on the prevailing foreign exchange rates when you entered into those financing agreements. Due to foreign exchange movements, these provisions may no longer be optimal. For example, a loan agreement could contain a provision prohibiting a borrower from incurring additional debt from third parties in excess of a sterling-denominated cap. If that borrower ordinarily incurs additional debt in a range of currencies, this provision may no longer be aligned with that borrower's requirements. In more complex financing agreements, changes to the market values of assets, which could result from foreign exchange movements, may trigger requirements to provide further collateral to lenders or to obtain more hedging.

Further, even if you are not exposed to foreign exchange risk, general volatility in the foreign exchange markets may impact your financing agreements. For example, a provision relating to the foreign exchange rate used for the revaluation of certain facilities (such as letter of credit facilities denominated in non-sterling currencies) may need to be reviewed to mitigate the risk associated with foreign exchange volatility.

Impact of Brexit vote: The Brexit vote triggered a fall in the pound against the euro and the dollar and affected various other exchange rates. It also caused some initial volatility in the financial markets and the outlook for the short to medium term is still unclear.

What can you do? As a preliminary matter, we recommend that you assess your exposure to foreign exchange risk and foreign exchange volatility.

Once this is established, you may wish to consider reducing your exposure to future foreign exchange movements through derivatives. In addition, you could investigate whether you are able to change the terms of your financing agreements so that they are more suitable for the current foreign exchange environment.

You may also wish to review cash pooling and other treasury arrangements which automatically convert a variety of currencies into euro and sterling.

Material Adverse Change

Background: Many financing agreements include a material adverse change provision which allows a lender to demand repayment of its loan if an event or circumstance occurs that has, or is reasonably likely to have, a material adverse effect on the business, operations or condition of the borrower or the borrower's ability to perform its obligations under that financing agreement.

Impact of Brexit: The specific wording of each financing agreement should be reviewed and applied on a case-by-case basis. Generally, we would not expect Brexit to trigger a material adverse change provision in financing agreements. This concept is not usually linked to the financial markets or political developments but, instead, to the business of the borrower and its ability to meet its financial commitments.

What can you do? We suggest you establish whether your financing agreements contain a material adverse change provision and, if so, assess whether Brexit would trigger this provision.

Tax

Background: Financing agreements contain detailed tax provisions that determine, amongst other things, whether a borrower is required to 'gross up' a payment that is subject to a tax deduction. If the gross-up applies, the borrower is required to increase the amount of its payment to the lender such that the lender receives an amount as if no tax deduction had been applied.

Impact of Brexit: Taxation is not generally an EU competence. Given this limited remit and the UK's existing bilateral tax treaties with all of the other member states of the EU, we do not expect material changes to the tax provisions contained in financing agreements as a result of the Brexit vote or Brexit itself, particularly in relation to UK borrowers.

These points will need to be reviewed, however, where domestic rules relied on by an EU borrower for exemption from withholding tax on interest are dependent on the lender being resident in an EU/EEA jurisdiction. In such a case, the relevant exemption could cease to apply to payments made to a UK lender following Brexit (unless the relevant bilateral tax treaty provides for similar relief).

What can you do? If you have financing agreements that will remain in place following Brexit between an EU borrower and a UK lender, we suggest you obtain legal advice about whether any withholding tax exemption will remain in place following Brexit.

Please also see the separate note titled "Brexit Briefing – Impact on Tax Matters".

Governing Law and Jurisdiction

Background: English law is one of the most popular choices of law for financing agreements due to its long-standing history and reputation for predictability and reliability. English courts have been similarly favoured for their consistency, independence, expertise, commerciality and relative efficiency.

Impact of Brexit: Although relevant EU laws such as the Rome I Regulation (which governs the recognition of parties' choice of law) will no longer apply to the UK following Brexit, it is unlikely that the English courts will depart from their long-standing position of giving effect to contracting parties' choice of governing law. Other EU member states bound by the Rome I Regulation will also continue to recognise parties' choice of English law.

The recognition of the jurisdiction of English courts and the enforceability of English court judgments in other EU member states are currently subject to the Recast Brussels Regulation, which will not apply to the UK following Brexit. However, whilst there are a number of possibilities as to how jurisdiction and enforcement of judgments may be regulated post-Brexit, we do not believe that the recognition of the jurisdiction of English courts, or the enforceability of their judgments in the EU, will be substantially compromised.

What can you do? We do not expect lenders and borrowers to amend financing agreements to change the applicable governing law or jurisdiction, or to move away from English law and the English courts for new financing agreements.

Please also see the separate A4ID publication titled "Brexit Briefing – Impact on Contracts and Choice of Law" although please note that arbitration is not typically used for loan agreements, save for emerging markets transactions.

Documentation Impact

Background: Brexit will necessitate certain technical changes to financing agreements as the customary formulations of certain provisions include references to specific EU legislation.

For example, each of the following provisions often includes a reference to specific EU legislation:

- the provisions that require a borrower to compensate a lender if that lender faces increased regulatory costs;
- "bail-in clauses" which are provisions that allow for, amongst other things, the liabilities of a failing financial institution in the European Economic Area to be written down or converted into shares;
- the representation given by a borrower on the primary location of its business;
- the representations and undertakings given by a borrower in respect of sanctions legislation; and
- the provisions relating to a borrower's auditors.

Similarly, the definition relating to cash equivalent investments also often includes references to the EU and its member states.

In addition, provisions regarding illegality, increased regulatory costs and "bail-in clauses" will also need to be tailored more generally to the UK's model for its interaction with the EU going

forward.

What can you do? At this time, it is not possible to establish what technical changes are required to the various references to EU legislation or to the provisions regarding illegality, increased costs and "bail-in clauses". This will depend on the nature of the UK's relationship with the EU following Brexit.

However, we recommend a review of your existing financing agreements for references to the EU and its member states. Once identified, you could amend your existing financing agreements to ensure that the UK is explicitly included or excluded from references to the EU and its member states. This could also be addressed in future financing agreements.

Checklist of Key Action Points

- Assess your exposure to currency fluctuations and consider whether amending your financing agreements and/or hedging is appropriate
- Establish whether your financing agreements contain a material adverse change provision and, if so, whether Brexit would trigger this provision
- Establish whether you have financing agreements that will remain in place following Brexit between an EU borrower and a UK lender and, if so, seek legal advice about whether any withholding tax exemption will remain following Brexit
- Review your existing financing agreements for references to the EU and its member states to assess whether the UK should be included or excluded from these provisions

If you would like more information about the subjects covered in this document or if your organisation is interested in receiving free legal advice by becoming a development partner of A4ID please contact probono@a4id.org

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