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Briefing note

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Brexit issues for directors of private equity portfolio companies

With the UK referendum on EU membership taking place this week directors should think about the potential implications for their businesses if the UK votes to leave. This briefing highlights for directors of private equity portfolio companies different areas of business which may be impacted.

If on 23 June 2016 the UK electorate vote to leave the EU there will be no immediate change to the UK's legal relationship with the EU or the rest of the world as the UK will have around two years to negotiate the terms of its exit. However there is uncertainty about what would happen if the UK were to leave which may result in an immediate reaction in the financial markets.

This briefing examines some of the issues for private equity portfolio companies in different sectors and business areas if the vote is to leave the EU.

In this case there are broadly five possible alternatives. The UK could seek to become a member of the European Economic Area (EEA) and European Free Trade Area (EFTA) like Norway, reach a series of bilateral agreements like Switzerland or join the EU customs union like Turkey. We think it is unlikely the UK will want to emulate these models. The fourth and most likely avenue, is that the UK would try to negotiate a deep and comprehensive free trade agreement (FTA) with the EU. If and to the extent this is not achieved the UK's relationship with Europe would default to one based on World Trade Organisation rules.

Financing

- The upcoming referendum and the possible vote to 'leave' creates a number of short-term practical considerations for corporate treasurers, as well as potential longer term repercussions. Businesses should consider the impact of volatility in FX rates, particularly those with revenue streams in one currency and borrowings or trade liabilities in another. Companies with collateralised currency hedges may be required to post extra collateral to cover mark-to-market exposures, which could also deplete existing lines of credit.
- Many companies with a financial year or half-year ending on 30 June will likely have to test covenants just seven days after the referendum. Check the bases of the exchange rate you would be required to use for foreign currency borrowings for these purposes (many will be smoothed by averaging over the relevant period, but some may be at spot rates).
- Businesses should consider their short- to medium-term requirements. A devaluation of sterling could also have repercussions for interest rates, the UK sovereign credit rating and indirectly corporate ratings. Market turmoil immediately following a vote to leave could also affect liquidity. We have seen a few Brexit-specific provisions creep in to recent deals, but these are by no means the norm.

Financial services sector

- The key mechanism which enables the cross-border provision of financial services within the EU (and the EEA) is the passporting system under the EU single market directives. Consider in which jurisdictions your UK business requires licensing or other requirements which are currently conducted under a passport which would no longer be possible if the UK were to leave the EU.
- If Brexit occurs and the UK does not join the EEA the other forms of relationship provide limited access for financial services due to the "prudential carve out" which allows countries to reserve the right to regulate their financial services for prudential and other reasons.

Tax

- There are potentially significant tax consequences of leaving the EU. The UK is used to relying on the free movement of goods and services and the freedom of establishment.
- Think about the impact of Brexit on the tax arrangements in your group structure. For example, dividends paid by EU subsidiaries to UK holding companies could become subject to withholding taxes.

Employees

- A significant number of EU nationals are employed in the UK in a variety of sectors. Any withdrawal agreement between the UK and EU will need to address the right of these workers to continue in their present jobs. A "grandfathering" system for current workers may be introduced. In addition new arrangements for migration would be required if Brexit occurred. Consider who might be affected in your business.

- A large portion of UK employment law comes from EU law, including legislation governing maternity and paternity leave, agency worker's rights and the protection of employees on a transfer of a business. However, if the UK leaves the EU this legislation would continue in place unless and until the UK decides to amend it.

Commercial contracts

- Consider if there are any standard terms contained in your contracts which could be triggered in the event of Brexit, for example illegality, market disruption and material adverse change clauses.
- Think about whether your commercial contracts have been drafted to take into account the existing legislative regime, for example long term outsourcing agreements where the pricing was dictated by the commercial risks taking into account current employment law.

Regulatory

- EU law provides a framework for a number of regulations such as product standards, licensing frameworks and public procurement rules. Most EU rules are implemented through UK law and if Brexit occurs it is likely they will initially remain in place, but they may diverge in the longer term. Consider whether your business will need to handle more difference in regulation.
- Is your business able to access the European market on the basis of a UK licence? As noted above the financial services industry would be affected, but it would also have an impact, for example, on the ability of the television industry in the UK to broadcast throughout the EU from the UK. There is also a risk that EU licensing regimes could discriminate against UK companies whereas currently UK companies can directly enforce their market access rights in the courts of other EU countries.

Intellectual property rights

- European Union trade mark (EUTM) and EU design rights co-exist with nationally granted rights in individual EU member states.
- If the UK leaves the EU there is no certainty about what would happen and the UK would in all likelihood be removed from the protection given by these rights. The thousands of brandowners and other rightholders around the world who protect their rights in Europe via the EUTM and other unitary systems will then be at risk of being deprived of protection if they do not have equivalent national rights in the UK. Potentially the UK could allow for some form of automatic or optional national right similar to the previous EUTM protection.
- Monitor what will be required to continue to protect these rights and be prepared to make further registrations before the UK leaves.

Trade agreements

- On leaving the EU, we expect the UK would seek to negotiate and agree its own concessions with the EU to mitigate tariffs and non-tariff barriers pushing up the price or effective cost of goods imported or exported to or from the UK.
- The EU has made fifty three trade agreements with non-EU countries which the UK is party to as a member. In the event of Brexit it will not be certain if these trade agreements will continue. The UK and the counterparty may agree modified agreements or they may have to negotiate new agreements. Absent agreements with the EU or other counterparties the UK would fall back on the WTO rules but the UK would need to negotiate separate tariffs and terms under the WTO too.
- Trade agreements would be lengthy to negotiate. Consider how this may impact your business and think about what your business would need a free trade agreement to cover and how to communicate this to the Government. Consider lobbying as an industry or trade.

Competition law

- Competition laws applicable in the UK and the EU are very similar but the UK would lose the benefit of the EU's 'one-stop-shop' for merger control. At present, mergers and acquisitions can be reviewed either by the CMA or the EU Commission. In future deals may fall to be reviewed by both, involving extra cost, time and resource.

Environment

- A large proportion of UK environmental law derives from EU legislation. Following Brexit, the UK could decide to change legislation, but compliance with certain aspects of EU legislation would be required to maintain the UK's environmental trading relationship with the EU.

Further information and advice

- If you would like to discuss the potential impact of Brexit on your business, please contact your Clifford Chance relationship partner.

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