The consequences of Brexit for commercial contracts

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Commercial: What are the implications for those drafting or negotiating contracts for a British exit from the European Union following the outcome of a referendum on this issue? What happened in Greenland when it left the EEC? Will English as a choice of law become less attractive for international commercial contracts? David Bowden, freelance independent consultant examines the implications, looks at the published research and talks to Ben Holland, Energy Disputes Partner of Squire Patton Boggs (UK) LLP in London, Alan Dunlop, former General Counsel of Amerada Hess (and latterly Director of the Center of American and International Law and former Chair of the International Bar Association's section on Energy, Environment, Natural Resources and Infrastructure Law) in Texas, USA and several contributors who did not want to go on the record for the possible consequences of Brexit.

Original news

The Conservative Party in its manifesto for the 2015 general election promised a referendum by 2017 on whether the United Kingdom should remain a member of the European Union or not. The Prime Minister has set out the amendments he wishes to see to the rules of the EU. What will happen if the UK decides to leave the EU (Brexit)? What happened in Greenland when it left the EEC in 1985? A selection of interviewees gives us their thoughts on the possible implications for commercial contracts - both business and public sector procurement ones.

What should a Brexit clause ideally contain and how would it work?

David Bowden (DB): We have not been able to find any specimens or precedents. The overwhelming majority of people involved in contract drafting we spoke to stressed the enormous benefit of English as a choice of law for contracts, and those involved in dispute resolution the advantages of litigation in an English court.

At the moment, the UK implements EU directives it has agreed in the Council of Ministers and these are incorporated into UK law either by primary legislation that the Westminster Parliament passes or more usually by means of a statutory instrument. If the UK left the EU, then the EU rules (the 'Community acquis') that the UK had incorporated would, unless any exit Treaty provided otherwise remain part of our law.

Would a Brexit clause simply amount to an agreement to consult with each other and make any necessary amendments to the contract post-Brexit? How could businesses minimise the risk that such clauses are found to be unenforceable?

Ben Holland (BH): He believes that these days it is never safe to hide behind that often-cited remark that agreements to agree are unenforceable under English law. Modern English law has adopted a more firm approach. It has been reducing the scope of the principle above, so as to give effect to the words used by the parties.

Brexit clauses in a commercial contract requiring an agreement to agree on how to deal with the consequences of Brexit would almost certainly be made enforceable under English law. Any Brexit clause would likely either allocate the risk of consequences of Brexit to one of the parties, or impose an obligation on the parties to negotiate a solution to rebalance the original commercial bargain.

Three factors that contribute to an obligation to negotiate being legally enforceable, all of which could all easily be incorporated into a Brexit clause, include:

- when the obligation is part of a wider contract that is already being fully performed, which would be the case with a Brexit clause, rather than an agreement to seek to enter a contract in the first place,
- where there is an objective standard that the parties are instructed to meet—in other words, a clear 'target' for them to aim for in their negotiations—any Brexit clause should therefore have a 'target' that is objectively ascertainable by English law, even as simple as reaching a 'reasonable solution', and
- when the obligation has a procedural mechanism for a third party to determine the correct outcome should the parties fail to agree, other than the courts, such as an arbitration provision, which would also be easy to incorporate.

DB: Looking at IT or data processing contracts in particular, data processing, consents or data exports are governed by EU Directive 95/46/EC (the Data Protection Directive). This has been implemented in the UK in the Data Protection Act 1998 (DPA 1998). Many contracts which concern data processing or outsourcing are either framed by reference to the way the Data Protection Directive works or make express reference to it.

If the UK left the EU, then it would not simply be able to repeal DPA 1998. This is because DPA 1998 (and its predecessor) implement the 1981 convention for the protection of individuals with regard to automatic processing of personal data. It is not proposed in Brexit that the UK leaves the Council of Europe as well as the EU. So while the UK could seek to try and unpick EU rules it did not like, it would not have a free-hand in this where these are embedded from other international treaty obligations.

This would also be the case with intellectual property too. For example, European wide patents granted under the European Patent Convention (EPC) are governed by another supranational agreement with its own machinery for registration and dispute resolution that is separate from the EU itself. If there was a Brexit, then this would not affect the EPC.

There is an EU wide trademark administered by the Office for Harmonization in the Internal Market (OHIM), running alongside this is the Madrid Agreement concerning the international registration of marks for trademarks (the Madrid Agreement). However, the Madrid Agreement permits a trademark owner to obtain an international registration for their trademark from the World Intellectual Property Office (WIPO). The trademark owner may then extend, or designate the protection to other member jurisdictions. This process sits under WIPO and will not be affected by Brexit.

Is the UK government or any public authority looking to provide any standard form wording in relation to a Brexit, such as for PF2 contracts?
DB: From the people we have spoken to, this would not appear to be the case at present. The public sector itself—even for cross-border transactions—at present, seems to invariably insist that the governing law of the contract is English law. While English law may change to accommodate what may need to happen if the UK leaves the EU, this will not affect the position that a contract will remain governed by English law.

It is by no means inevitable that even if the referendum shows a majority of UK voters in favour of leaving the EU that this will be the end result. What is likely to happen is a period of negotiation between the UK and the EU so that the UK could remain in the EU on terms which it felt were acceptable. To bring this about, it is highly likely that a new treaty will be needed.

Addleshaw Goddard LLP (AG): It conducted a short survey before a recent panel event on this at their London office. Nearly half of respondents to this survey felt that giving greater powers to Parliament to block proposed new EU legislation should be a priority for the UK government when it gets to the point in these negotiations with the EU on the terms on which the UK will remain.

DB: It remains to be seen what HM Treasury will do. VAT is a tax that, while well known, is purely derived from EU law—mainly the 6th Council VAT Directive 77/388/EEC, as amended. This has provided bountiful litigation over the years as to whether a Jaffa cake is a cake or a biscuit and should have VAT on it or not, and the like.

Over a fifth of the Treasury's income is derived from this indirect tax. While a Brexit would mean that the UK would no longer be bound by these complex EU rules, it is highly improbable that it would

abolish VAT. The UK could introduce a sales tax of its own but then that could leave larger businesses with the compliance costs of both regimes.

Are any UK trade associations looking to provide any standard form wording in relation to Brexit to cover private sector contracts?
AG: There are some areas that are more likely to be affected by an UK exit from the EU than others. The Addleshaw Goddard survey in relation to financial services highlights these sectors as the most prone to be affected by a Brexit:

- wholesale trading markets,
- capital markets,
- finance.

Less than one in six respondents thought that the financial services sector of the UK economy would not be damaged by a Brexit or that the UK would continue to flourish outside the EU.

DB: Some trade associations do not provide standard contract wording to their members as they focus on representation or lobbying. We have not yet seen any trade associations showing any great keenness to provide Brexit clauses, but if they are to materialise it is more likely to be in the capital markets space than anywhere else. It should be noted that UK financial services firms authorised by the Prudential Regulation Authority or Financial Conduct Authority (FCA) on the whole benefit from passported authorization which enable them to trade in other EU member states.

If there was a Brexit, there is a real risk that this automatic passporting would come to an end. This would then have an additional compliance cost for UK financial services businesses. It is likely that artificial barriers could then be placed in the way of UK businesses in seeking to obtain equivalent authorisations in other EU member states.

The Mortgage Credit Directive 2014/17/EC (MCD) is due to be implemented in the UK by 21 March 2016. In a consultation paper on the implementation of MCD, HM Treasury said:

> '*The UK government does not believe that the MCD offers many benefits to UK consumers beyond those already provided by the high level of protection offered by the existing FCA regime for mortgages. However, it does add a number of costs to UK industry…. The government does not believe that it offers much benefit in this area in practice because it does not address the primary obstacles for such a market....The UK has therefore been sceptical about the value of the MCD*.'

If a Brexit appears likely, then that may give the UK government an excuse to delay implementation of EU directives.

What are the risks if no Brexit clause is included in a contract?
DB: Nearly all respondents were clear in their enthusiasm for English as a choice of law for contracts and English courts or arbitrators to settle cross-border commercial disputes. Where a contract provides that English law will apply, then English law, whatever it then is will continue to apply after a Brexit.

The real danger is the reverse situation where a contract makes an imperfect provision for Brexit.

What other clauses such as termination, material adverse changes, governing law, and so on would need to be considered and what changes would need to be made?
DB: Again it is unlikely that these clauses would need wholesale revision. Of course, contract drafters should draft contracts with what could happen in the future and try to provide for this in them. It is unlikely that any business would want a contract to terminate simply because the UK left the EU, but there may be exceptions. The UK would continue to be governed by its own government so a material adverse change clause would not seem to achieve anything. Prudent drafters may want to provide that a Brexit of itself would not trigger any material adverse change provisions. Contracts will continue to be governed by English law—whatever that may be in the future—where English law is the choice of law.

Would EU law form part of English law on contracting, but then no longer after a Brexit? Or are there likely to be transitional arrangements?
DB: A barrister who responded wondered what would happen should the UK vote to leave the EU. At that point the UK will have a free hand in negotiating its future with the EU. However, despite this,

there will be a clear attraction for the UK in having its legislation mirror that of the EU. The UK will continue to look at what the EU is proposing in relation to new directives or regulations. Where the EU proposes something that the UK is broadly in agreement with it is likely that the UK will copy it with whatever differences are required to make it work in the UK. This will still allow the European Commission to do the initial thinking—over which the UK will have no influence or control—and then the temptation will be for law makers in the UK to copy it without exercising any independent analysis of their own.

AG: Nearly half of the respondents to the Addleshaw Goddard survey thought that UK membership of the European Economic Area (EEA) would be preferable if the UK voted to leave the EU. If this happens then the scope for jettisoning EU rules would be considerably reduced. Interestingly 43% of respondents to this survey felt that the UK should ensure that the City of London's financial markets are safeguarded from EU regulation if there is a Brexit. Given the uncertainties, nearly three quarters of respondents wanted the referendum to be held in 2017 and not before.

What would happen to contracts where EU law plays a material role such as where an EU body is referred to?
DB: A general counsel at a public sector organization thinks that the biggest impact of a Brexit would be in the field of competition law. This is a particular issue for the public sector because it has to comply with the EU rules on state aid and procurement.

This means that, at present, public sector procurement contracts have to be advertised in the Official Journal of the European Union (OJEU). This is done for transparency and to give everyone an equal chance to bid for valuable public sector contracts. Because of the transparency aspect—but also because of the wider pool of potential tenderers—the attraction of continuing to advertise public sector procurement contracts in the OJEU is clear. If the UK did not do so, it would have to devise an equivalent system of its own.

On state aid, following Brexit the UK would no longer be subject to these when it seeks to grant state aid, such as the bailouts it gave to banks such as Royal Bank of Scotland or Northern Rock. The UK would not need approval of these types of assistance from the European Commission. They could be a sting in the tail however, because if the UK was no longer an EU member it could no longer complain to the Commission about state aid that other EU member states were granting to undertakings in their countries. There is a risk of retaliation that some EU countries may grant subsidies to businesses in their countries with the aim of under cutting UK business in some areas.

Does the threat of a Brexit and the uncertainty that it engenders mean that fewer international businesses will choose English law as a governing law?
Alan Dunlop (AD): He is quite clear that he does not believe this to be the case. He says that there are many reasons why large multi-national corporations such as Amerada Hess choose English law for cross-border contracts. Principally these are:

- English common law is respected as a comprehensive and fair body of law in relation to commercial matters—even in civil law countries,
- English courts have an international reputation for comparative speed and fairness towards all litigants with blindness towards the nationality of the litigants—this is in contrast to many US states, where in many cases the courts are perceived by foreign parties as offering an inherent home team advantage,
- English law is well understood in the critically important world of international arbitration, and
- decrees, judgments or orders of the English High Court are most often met with respect and enforced around the world.

For this reason he really cannot see it making any significant difference to the use of English law by major international corporations. None of the reasons above for the choice of English law would change. The UK's EU membership was never a factor considered—at least in his experience in the oil and gas industry—in any discussion of choice of law for a commercial contract. In any event, all the provisions of EU law which have been incorporated into, or enacted as part of, UK legislation would not simply disappear overnight.

BH: He shares these concerns. As an international disputes lawyer in the field of energy and resources, he has great concern if English law would somehow cease to be as widely used as it is at present. The choice of law is often critical as to what governs a deal. English law's attractiveness to

commercial parties around the globe has little to do with its EU membership. Centuries of commerce has led to principles of English law that reflect a high degree of commercial common sense. It is this perceived reliability that causes English law to be turned to. Any Brexit would not undermine this. Nor does the current risk of Brexit mean that English law has stopped being used for international energy and resources contracts today.

On the contrary, many energy and resources companies seek the certainty, objectivity and reliability reflected within English law. Although EU law principles have become clearly embedded into English law, and have been helpful for many, principles such as good faith, state aid restrictions and consumer protection and employment regulation. Moreover the open-textured or principles-based approach of EU law itself is seen by some to corrode the sharp edge of English law. In fact, many clients outside the EU, such as energy and resources companies, would see the absence of EU principles within the body of English law as increasing the likelihood that the contractual words used were upheld.

DB: This view is mirrored from those we spoke to in the public sector where again the use of English law as a choice of law is an almost invariable choice. English law is one of the oldest legal systems in the world and its basic principles are universally respected. The perception is that contracting partners accept English law as the proper law of public sector contracts—even for cross-border ones—albeit sometimes grudgingly because of this reason and not because the UK is a member of the EU.

AG: Nearly two-thirds of business respondents to the Addleshaw Goddard survey favoured the UK's continuing membership of the EU on the proviso that concessions were sought to protect the interests of British businesses especially those in the financial sector.

Are there any lessons to be learnt from previous exits from the EU such as when Greenland left the EEC in 1985?
DB: As part of the research for this piece we contacted two of the largest law firms in Greenland—Nuna Law and Malling & Hansen Damm—to try and find out what happened when Greenland left the EEC in 1985. Despite a number of reminders we were unable to obtain any response. This may not be surprising as this exit happened 30 years ago.

However, we should put this into context. Greenland joined the EEC in 1973 when Denmark joined. By 1979 Denmark had granted Greenland home rule and so it held an 'in/out' referendum on EEC membership in 1982. A majority of the Greenland population of 56,000 people voted to leave and Greenland duly left the EEC in 1985. Greenland was a member of the EEC for less than 9 years. The communitaire acquis 30 years ago was considerably less than now – there was no Maastricht treaty, no social chapter, no Euro, etc.

Greenland remains heavily dependent financially on Denmark—which of course remains in the EU—but is not in the Euro area. Denmark gives Greenland a large block grant every year to subsidise public services in Greenland. Greenland remains dependent on fish for 90% of its economy and has to import a large number of other things. As Greenland imports much, then whether it is a member of a trading block is not as important as it would be if it were a large exporter.

After leaving the EEC, there was no immediate effect on the economy in Greenland, but it did suffer a recession in the early part of the 1990s. Since then Greenland has run a tight fiscal policy which on the whole has generated budget surpluses and low inflation. It was not affected by the banking crisis of 2007-09 which affected nearby Iceland so badly. However, this must be put in context. The size of GDP in Greenland is just under $1.3Bn, but this pales into insignificance when compared to that of either the UK ($2.8Trn) or the Euro area ($13.4Trn). Similarly, the population of Greenland represents only about 0.01% of that of the EU as a whole.

Greenland remains isolated not just geographically—it is neither a member of the EEA or European Free Trade Association (EFTA). It benefits to some extent, when needed, from Denmark's membership of the EU. Greenland, like the UK, is not in the Schengen area. While, not a trading bloc, Greenland is a member of the Council of Europe.

Interviewed by David Bowden.
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