BREXIT: IMPLICATIONS FOR CONTRACT CONTINUITY AND REPAPERING

One of the key questions firms need to consider in their Brexit planning is how to deal with cross-border financial services contracts. In a scenario where the UK leaves the Single Market and no deal covering financial services is agreed, firms will lose the right to passport financial services activities between the UK and EU27. This raises uncertainties and a potential cliff-edge risk for the continuity of existing cross-border contracts, which currently underpin many firms’ businesses.

Firms will need to consider whether and how these risks to contract continuity may be mitigated, or whether to move existing contracts to a locally-licensed entity, which may itself require a complex repapering exercise. This briefing highlights some practical implications for firms when considering these issues.

Brexit contingency planning and loss of passporting

As Brexit negotiations continue, there remains a great deal of uncertainty about what a future relationship between the UK and the EU might look like. However, as March 2019 draws closer, many firms are significantly advanced in developing contingency plans for Brexit.

In particular, UK regulators have been urging firms to ensure that their plans contemplate a “no deal” scenario, where no special agreement on market access is reached for financial services. On 8 February 2018, the European Commission also published a set of notices addressed to stakeholders across a range of financial services, setting out the consequences of Brexit for financial services and highlighting the need to prepare for the possibility of a “no deal” Brexit.

In this scenario, firms will no longer be able to provide cross-border financial services between the UK and EU27 in reliance on current financial services passporting rights. Therefore, firms will be considering how to continue to provide financial services to their client base post-Brexit, for example through seeking new authorisations and/or moving business to a locally-licensed entity. Firms also need to consider how to deal with existing cross-border contracts and transactions that extend beyond March 2019 (or possibly beyond any transitional period that may be agreed). This briefing focuses on the latter question, and highlights various practical issues for firms to consider when deciding whether or not to transfer legacy contracts and business.

This briefing primarily discusses these issues from the perspective of a UK firm providing services in or into the EU27, but similar considerations will also apply to EU27 firms that currently rely on passporting rights to provide financial services in or into the UK.
Uncertainties for continuity of existing contracts

The loss of passporting rights creates significant uncertainties for the status and continuity of existing cross-border contracts for financial services, particularly those which contemplate the ongoing provision of financial services or carrying on of regulated activities during the life of the contract.

If a firm no longer has a cross-border licence to provide those services or to perform those activities, this raises a number of important contractual questions:

- Is it illegal for the firm to exercise rights or perform obligations under the contract? If so, what are the contractual implications of this?
- Is the validity of the contract affected?
- Is the ability of a party to enforce the provisions of the contract affected, either as a matter of law or because as a practical matter, the party seeking to enforce the contract would need to take actions for which it no longer has a licence?
- Are the parties hindered or prevented from making non-material amendments to, or from terminating, the existing contract? In the normal course of business, parties may want or need to fine tune or amend the contract to respond to changing market conditions. But would such amendments trigger licensing requirements and/or be prohibited if the firm does not have a licence?

The answers to these questions are not straightforward and may well differ depending on the type of contract in question.

Given these uncertainties for the continuity of existing contracts, the main solution that many UK firms are looking at is to transfer existing contracts to an EU27 licensed entity, so that there is no disruption to the provision of services to clients after the UK leaves the EU. We consider some of the practical issues for re-papering and transferring client relationships at the section headed “Repapering considerations” below.

Reasons for leaving business behind

Despite the uncertainties and risks for contract continuity discussed above, there are a number of commercial and logistical reasons for leaving existing business behind.

Scale of the task

The volume and value of financial services transactions and products being provided on a cross border basis from the UK to the EU27 is significant. AFME and UK Finance have estimated that €1.3 trillion of UK-based bank assets are currently being used to provide cross-border financial products and services to governments, individuals and businesses.1

This cross-border business is underpinned by contracts and transferring, restructuring and potentially terminating all of these contracts would be a mammoth task, fraught with operational and logistical issues and requiring significant investment of management time and resources.

Brexit risk for contract continuity

If a firm no longer has a cross-border licence due to loss of passporting rights:

- Does performance of existing contracts become illegal?
- Does the contract itself become invalid?
- Are rights to enforce the contract affected?
- Are parties prevented from amending or terminating contracts?

Commercial and transactional issues
Second, the transfer or termination of contracts raises various commercial and transactional issues. For example:

- counterparties may seek to renegotiate contracts to obtain better terms, or to take into account factors such as changes to the group’s structure or business model;
- where contracts are moving to a different group entity, the credit risk of the new entity may be different;
- collateral pools would be split between entities and so some netting and other efficiencies may be lost; and
- if a new financing transaction needs to be put into place, the commercial terms, covenants and/or pricing may be different from those originally negotiated.

Tax implications
There may be a tax impact on financial transactions and financial documentation that results from a financial institution’s Brexit planning, particularly where it involves rebooking or transferring transactions, or merging entities. There is a risk that tax liabilities could crystallise (for both parties) and there could be additional ongoing expenses.

Capital and other impacts
Institutions may decide that they do not want to move a particular class of transactions to a different group entity due to the impact on either the transferring or receiving entity. For example, transferring a large book of existing contracts to a newly established EU27 entity may have a significant impact on the capital requirements for the new entity, or give rise to operational, tax or accounting complexities that may be difficult for the new entity to manage. Therefore, it may not make economic or operational sense to transfer certain types of contracts.

Client doesn’t want to move
Clients or counterparties may not want contracts to transfer to another group entity for a variety of reasons, including potential changes in economic terms, credit risk, splitting of collateral pools and netting sets, and potential tax implications arising from a transfer.

In some cases, firms may need client consent for a transfer and so may find that they are unable to transfer these contracts. In other cases, even if firms have the legal ability to transfer contracts, they may nevertheless decide not to transfer these contracts from a client relationship perspective.

Client or contract cannot be identified
Finally, there may be “dead register” type considerations that mean a contract cannot be transferred. This might arise because a firm’s historical information is out of date or incomplete, meaning that they do not have sufficient information on the counterparty, jurisdiction or transaction (or may not be able to find the contract) in order to effect a transfer.

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Potential solutions to secure contract continuity

Therefore, it is important that solutions are found to mitigate contract continuity risks and allow institutions to leave at least some legacy cross-border contracts behind in a UK entity post-Brexit. The most comprehensive option would be a UK-EU27 level agreement providing for grandfathering of legacy contracts. However, even if a blanket agreement of this sort cannot be reached, firms may be able to rely on other solutions, at least for some of their legacy contracts.

Grandfathering of legacy contracts under Withdrawal Agreement

A solution at UK and EU27 level for grandfathering of legacy contracts would minimise uncertainty for firms and allow them to retain all or most of their legacy book of contracts where they are now. This could for example be achieved through a provision in the Withdrawal Agreement (and reflected in a UK implementing act) providing that the loss of the right to passport on a cross-border basis does not affect the validity, rights or liabilities under, performance, enforcement, amendment and termination of existing contracts.

Reliance on transitional period to run down back book

A transitional period during which firms could continue to rely on current passporting rights would provide firms with a longer period of time to “roll on/roll off” activity to an EU27-licenced entity. If there is no comprehensive agreement on grandfathering of legacy contracts, a transitional period may be crucial to allow firms to run down their back book while still being able to rely on passporting rights.

Nevertheless, there may still be a rump of assets and associated contracts left at the end of the transitional period and, absent any future arrangement with the EU, a solution would be needed in respect of those contracts. Therefore, reliance on transitional arrangements alone may simply postpone the “cliff edge” risks for continuity of contracts, albeit in relation to a smaller population of legacy contracts remaining at the end of the transitional period.

Individual Member State solutions

If an EU-wide solution is not agreed, individual EU27 Member States may nevertheless decide to legislate to provide for continuity of contracts, possibly through grandfathering of existing contracts or by providing for an interim licensing regime to give firms more time to run down their back book.

Alternatively, EU27 regulators may provide for some form of regulatory forbearance. This is an interesting potential solution as there may not be any legal basis for such forbearance at EU or Member State level, meaning firms would need to assess the level of enforcement risk in their decision making. Firms would need to consider whether there is sufficient legal certainty to rely and act upon any such regulatory forbearance.

Contract-by-contract analysis

Finally, in the absence of a legislative or regulatory solution, firms would need to conduct a contract-by-contract and jurisdiction-by-jurisdiction analysis, in order to determine whether:

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• elements of the performance of the contract, or amendment or termination of the contract, would constitute a regulated activity for which the firm is no longer authorised; and / or

• the firm is permitted to perform those elements of the contract (or amend or terminate the contract) under the regulatory regime of the Member State(s) where services are being provided.

This is likely to involve complex factual and legal analysis, as different Member States may have different local rules on whether a particular lifecycle event or element of performance of the contract is regulated.

In some cases, it may be possible to conclude that licensing requirements will not be triggered even for activities that would ordinarily be regulated, for example if a firm is able to rely on reverse solicitation. However, the variations in different Member States’ reverse solicitation regimes can be difficult to navigate. For example, in the case of novation of a financial contract that would ordinary trigger licensing, some Member States may not require the firm to be licensed where the novation was initiated by the client. On the other hand, if the relevant reverse solicitation regime requires the overall relationship to be reverse-solicited from the outset, this may be much more difficult to satisfy.

In addition, a lifecycle analysis is likely to provide only limited help for firms when responding to business as usual client requests to modify or extend contracts, or to deal with financial distress scenarios.

Repapering considerations
As discussed above, the loss of the financial services passport without any mitigants will inevitably lead to books of EU-facing client business being transferred. We now turn to focus on how UK firms may be able to move existing business to an EU27-licenced entity.

Any business transfer – whether transferring a whole business or just part of a business – is a complex undertaking and requires consideration of many different component parts, including the transfer of employees, IT systems, premises, outsourcing arrangements etc. However, consideration of these broader issues lies beyond the scope of this briefing. Instead, we are focusing on the client-facing piece of the jigsaw; in other words the question of how to transfer existing client relationships and how to onboard new clients once the business has transferred.

The answer to these questions and the complexity of the documentation exercise depends on a number of factors. The most important factor in this equation will be the method the firm is using to transfer the business: is it a statutory tool, such as a Part VII transfer or cross-border merger or is it conducting a “manual” transfer or novation, either within the same legal entity or to a different entity?

There are also a number of other significant factors and choices that will influence how easy or complicated the documentation process needs to be. Some of the most important issues in this context are highlighted below.
Transfer methods
To start with, firms will need to look at the different transfers methods that may be available for its business and what impact these may have on the re-documentation exercise. It is worth distinguishing between statutory tools on the one hand, and “manual” tools on the other.

Statutory tools
The statutory business transfer tools, including under Part VII FSMA and the EU cross-border merger mechanism, have significant advantages when it comes to the transfer of client business. This is because they involve the least amount of customer intrusion and tend not to trigger regulatory requirements that may otherwise apply to new contracts. Under a statutory business transfer, existing client contracts will, subject to some limitations, be swept up in the general transfer or merger of business, which means that there is no need for any manual novations.

Furthermore, in the case of a Part VII transfer in particular, the English courts have extremely wide powers to unilaterally amend existing contracts to make them fit for purpose for the transferee entity. They can go so far as to clone existing contracts, or order them to be split if appropriate. Of course, the courts need to be persuaded that any given documentation approach is in the customers’ best interests, but this is why the Part VII process is sometimes called a “virtual repapering” exercise.

However, the Part VII tool also has some significant limitations, including the fact that it is only open to banks transferring a part of their deposit-taking business to the transferee entity (or to insurance firms seeing to transfer their (re-)insurance business). That rules out investment firms entirely, which make up a significant proportion of UK entities seeking to transfer business to the EU27.

Also, as Part VII FSMA is a UK scheme, its recognition needs to be tested in an international context. That is not to say that it doesn’t work, but firms will need to investigate its effectiveness and may need to implement local top-up schemes in certain EU27 jurisdictions.

“Manual” transfer methods
Given that statutory tools to effect client repapering are not available to all types of firms, some firms many want or need to transfer business “manually”. The particular transfer method used is likely to depend at least in part on a firm’s current group structure.

Branch-to-branch
Some groups with existing EU27 entities will be looking to transfer businesses from the London branch of an EU27 entity to the head office, or to another EU27 branch. Because the transfer takes place within the same legal entity, a branch-to-branch transfer will not, generally, constitute a transfer of assets and liabilities.

From a documentation perspective, this means that less extensive due diligence on existing contracts is likely to be required, and many mechanical amendments to contracts, such as changes to counterparty names and notice provisions, could be made by notification.

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However, it is likely that there will still be some products and agreements that will require formal consents to be given to a change in branch or office. For example, this will be the case where there are tax sensitivities around a change in booking location, such as for derivatives contracts or loan products.

**Bilateral**

It is likely that a majority of firms will be looking at effecting a bilateral business transfer to another entity in the EU. This will inevitably result in a higher level of customer intrusion than the other transfer methods, as from a documentation perspective, a bilateral business transfer will require consents by clients and counterparties to the novation of their existing contracts.

In addition, the novation of contracts to a transferee entity may also trigger certain regulatory requirements, such as reporting and mandatory margining of derivatives, even if the original legacy transactions were exempted from such requirements.

**Practical questions about repapering**

So, having accepted that the re-documentation exercise will involve some degree of pain and effort, which will be most acute in the bilateral transfer scenario, there are other key factors and decisions that will determine just how complex an exercise this will be.

**Relationship documents only or existing transactions?**

The first question is about the end state that the firm is trying to achieve through the re-documentation exercise:

- is the firm looking to on-board existing client relationships on to the new entity without transferring existing transactions? or
- is the firm seeking to transfer the whole of the existing relationship to the new entity, including underlying transactions?

The first exercise is sometimes referred to as “pre-papering”, i.e. getting the EU27 entity ready for business from a documentation perspective by replicating existing Terms of Business and Master Agreements. This can be contrasted with “re-papering”, which implies a full transfer of the existing client relationship, including open transactions and positions.

At this stage, some firms may decide to “pre-paper” only, either because they do not intend to transfer certain types of existing contracts due to the various reasons discussed above, or because they may hope to benefit from a transitional period or that Brexit negotiations may yield some positive outcomes in terms of grandfathering concessions for existing transactions.

There may, however, be other factors leading firms to take a complete re-papering approach at the outset. For example, customers may be reluctant to split netting sets by facing two different entities in the same group; and some firms may prefer to avoid what is effectively a two-stage repapering process.

**Key decisions for repapering**

The following decisions will affect how complex the exercise is likely to be:

- “Pre-papering” v “re-papering”
  - Amend relationship documents only or legacy transactions too?
- “Replicate and amend” or new documents
  - Limit amendments to those that are strictly necessary or adopt a local form of documentation?
“Replicate and amend” or new documents?
The next big question that will drive the complexity and effort involved in the re-documentation exercise is the chosen methodology or approach to repapering. In particular, there are broadly two approaches that firms seem to be following:

• The first approach, sometimes referred to as “replicate and amend”, envisages the replication by the EU27 entity of all the existing contractual terms of the UK entity, with only limited amendments made as strictly necessary.

• The second approach envisages the EU27 entity agreeing a completely new form of documentation that may be more common in the local market, or may already be used by that EU27 entity in the context of existing EU27 business.

The obvious advantage with the “replicate and amend” approach is that it makes for an easier customer repapering journey, as the client is essentially asked to agree to documents that he or she is already comfortable with, with some mechanical amendments that are absolutely necessary or desirable.

However, the main disadvantage of this approach is that is that the new contracts between the EU27 entity and EU27 clients may miss some of the local nuance that would otherwise be addressed if starting the customer relationship from scratch. A good example of where there can be significant local variance is in relation to local client asset or client money rules.
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