

Brexit and Contractual Continuity

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Brexit and Contractual Continuity

Deepak Sitlani, Linklaters LLP

The Issue



- > On exit, E.U. financial services directives will no longer grant **passporting rights** to E.U. investment firms/ credit institutions (in the U.K.) or U.K. investment firms/credit institutions (in the E.U. 27 jurisdictions)
- > **Insurance** contracts:
 - Local law question as to whether performance under existing insurance contracts requires a licence, eg. residency of insured/location of property/where vehicle is registered
 - U.K.: is insurance contract **‘effected and carried out’** in U.K.?
- > **Derivative** contracts:
 - Generally will only be narrowly defined local law exemptions to authorisation requirements, including acting on a ‘reverse solicitation’ basis
 - Overseas persons exemption may be available to E.U. 27 counterparties under the U.K. regime
 - Local law question as to whether continued performance of existing obligations requires a licence
 - Certain ‘lifecycle’ events which occur during the life of a legacy cross-border OTC derivative transactions may also trigger authorisation requirements

Lifecycle events under derivative contracts

Multi jurisdictional analysis with respect to investment firms and credit institutions (and branches thereof) in France, Germany, Italy, the Netherlands, Spain and the U.K.

Unlikely to be regulated

Payments and settlement
 Unwinds / portfolio compression (where no new transaction is entered into) (outside the U.K.)

May be regulated

Amendments
 Exercising an option (in the U.K.)
 Transfers / substitution of collateral under TTCA (in the U.K.)

Likely to be regulated

Rolling an open position
 Novation (will depend on exactly which capacity acting in, and identity of third party)
 Unwinds / portfolio compression (where new transaction is entered into) (plus any other type of unwind / portfolio compression in the U.K.)

Brexit and Existing Financial Contracts

**Professor Hugh Beale QC (Hon), FBA, University of
Warwick**

Introduction

- Loss of passporting rights: existing (“legacy”) contracts
 - Contracts made while firm had passport rights
 - Wholly or partly unperformed
- Need to identify practical issues
 - Help from FMLC Working Group on Continuity of Financial Contracts
 - Errors and omissions my own

'Further Services'

- Concern raised: not carrying out contract authorised when made
 - the provision or return of collateral
 - termination of an existing transaction (including pursuant to a portfolio compression arrangement)
 - mere exercise of option
- Further services under a existing contract
 - arranging for exercise of an option
- Or contemplated by contract parties
 - E.g. rolling open position by termination/new
 - swaps dealer acting as a compression agent

Or Performance Generally?

- I am not confident problem is limited to “further services” agreements
 - See below



Contractual Adjustments

- Clauses may allow parties to avoid problem
 - Substitution of authorised party
 - Re-location of party
- Feasible only if firm has unilateral right
 - Impractical to get counter-parties' agreement



Continued Authorisation

- Assume U.K. will treat
 - U.K. firms as authorised
 - E.U.(W) Bill: FSMA 2000 + Regs left in place, subject to amendments
 - E.U. 27 firms as authorised in U.K.
 - Bank of England announcement
 - Should cover effecting and carrying out of insurance: SI 2001/544 r 10
- U.K. firms dealing in E.U. 27
 - Third Country provisions
 - Some: may act provided do not “solicit”

Possible Consequences of Loss

- General contract law, e.g.
 - Performance illegal
 - Contract frustrated
- Contract terms
 - Termination event
 - Event of default
- Criminal/ civil/ administrative sanctions in E.U. 27



General Law Consequences

- Governing law?
- Whether further services must be carried out in E.U. 27?
 - Also: whether enforcement in E.U. 27 necessary



English Law, Performance >E.U. 27



- Governed by and legal under English law
 - Not affected because illegal where made
- Some uncertainty
 - ‘Courts will not enforce a contract made between parties to further an adventure to break the laws of a foreign State’
 - Only when to be carried out in place where illegal?
 - LoA sufficiently serious?
 - Cf FSMA, not illegal, unenforceable
 - *Apotex*: illegality under foreign law like domestic
 - *Patel*: factors based, non-enforcement disproportionate?

English Law, Performance in E.U. 27

- No enforcement of contract that is illegal in place where must be performed
 - *Ralli Bros* (subsequent illegality)
 - *Toprak Mahsulleri* (initial illegality)
- Rome I Reg Art 9(3):

“Effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, in so far as those overriding mandatory provisions render performance of the contract unlawful...”
- An overriding mandatory provision?



Where are Services Performed?

- Where are further services to be performed?
- Insurance
 - Some E.U. 27 States treat as carried out where risk is situated
 - *Ralli Bros* may apply
 - Which law decides where contract is to be performed?



English Law, Enforcement in E.U. 27

- If enforcement in E.U. 27
 - Counter-party has no assets in U.K.
 - Collateral is held in E.U. 27
- Recognition of English judgments: > scope of paper
- Application of English law and Rome I Art 9 unpredictable
- Court might simply apply own law ...



Governing Law: E.U. 27

- Not uncommon for contracts to be governed by counter-party's law
 - E.U. 27 court will apply own law
 - May well hold unenforceable because illegal (or equivalent)
 - Might also amount to change of circumstance
 - Court may adjust or terminate contract
 - E.g. German and now French law
 - Cf introduction of the Euro
 - Unpredictable

General Law: Conclusions

- Risk that contract unenforceable slight if
 - English law governs
 - Performance does not have to be in E.U. 27
 - Enforcement does not have to be in E.U. 27
- Risk considerable if
 - English law governs but performance/ enforcement in E.U. 27
 - Which law decides where performance must be?
 - E.U. 27 law governs

Performance of Existing Contracts

- E.U. 27 may require authorisation for carrying out existing contract
- MiFiD 2 Art 5(1)
 - “Each Member State shall require that the provision of investment services *and/or the performance of investment activities* as a regular occupation or business on a professional basis be subject to prior authorisation ...”
- LoA might affect all existing contracts, not just further services

Contractual Consequences

- Termination events: illegality, force majeure
- Probably not triggered by mere performance
- Further services: might trigger
 - If unenforceable because illegal, contract (or relevant severable part) frustrated
 - Termination clause irrelevant, parties cannot exclude rule
- If not unenforceable because illegal (e.g. E law, no performance in E.U. 27 required, or disproportionate)
 - Is clause triggered by any illegality, e.g. mere prohibition?
 - Question of construction

Misrepresentation Event of Default

- Representation that legal under applicable law, all consents obtained
 - At time contract made, so not triggered by mere performance
 - But if further services and representation repeated, event of default



Penal or Administrative Sanctions

- E.U. 27 may impose criminal or civil penalty, administrative sanction on firm acting after LoA
 - Loss and reputational damage
 - Needs investigation



Conclusion

- Real risk that loss of authorisation will affect
 - existing contracts/ agreements for further services to supplement existing contracts
 - Unenforceable because illegal, or
 - Even if not illegal, possibly cause event of termination or default
 - Where E.U. 27 law governs
 - Where English law governs
 - If performance has to be made in E.U. 27
 - If enforcement needed in E.U. 27
- Criminal, etc sanctions

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Contractual Continuity on a Hard Brexit: Human Rights and Reverse Solicitation Solutions

Thomas Donegan, Shearman & Sterling LLP

Introduction



E.U. / ECHR Right to Property

- Right to property is codified in:
 - European Convention of Human Rights (ECHR)
 - E.U. Charter of Fundamental Rights (E.U. Charter)
- Applies to legal persons as well as natural persons
- ECHR, Article 1: *“Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.”*
- E.U. Charter, Article 17(1): *“Everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions. No one may be deprived of his or her possessions... The use of property may be regulated by law in so far as is necessary for the general interest.”*
- Where the ECHR and E.U. Charter contain equivalent rights, the E.U. Charter is to be applied at least as generously as the ECHR

E.U. / ECHR Right to Property

- The European Court of Human Rights (ECtHR) and national courts have interpreted the term “possessions” to encompass many forms of property, **including contractual rights**
- The right applies to possessions, including contractual rights, provided that they give rise to an asset
 - *Murungaru v Secretary of State for the Home Department and Others*, [2008] EWCA Civ 1015: a contract for private medical treatment did not constitute an “asset” under the ECHR
- Transmissibility, where it does exist, is relevant because marketability is relevant to the economic value of intangible rights

E.U. / ECHR Right to Property

- The ECJ has held that “possessions” under the E.U. Charter encompass contractually acquired rights which “*have an asset value creating an established legal position under the legal system, enabling the holder to exercise those rights autonomously and for his benefit*” (*Sky Österreich v Österreichischer Rundfunk* (C-283/11) [2011], para 34)
- ECtHR jurisprudence suggests that the key question is whether the contract gives rise to financial rights and interests and has an economic value (*Paeffgen GmbH v Germany* (Application Nos 25379/04, 21688/05, 21722/05 and 21770/05) (unreported) given 18 September 2007, pg. 8)
- Under the ECtHR, assignability is important (but not determinative).

E.U. / ECHR Right to Property

- U.K. Courts (under ECHR):
 - Relevant indicia of “property” are tangibility, assignability, realisability and economic value (*Murungaru v Secretary of State for the Home Department and Others*; *Breyer Group Plc v Department of Energy and Climate Change* [2014] EWHC 2257 (QB) para 51)
 - “[T]ransmissibility cannot always be a touchstone of a possessory entitlement” (*R (on the application of Malik) v Waltham Forest NHS Primary Care Trust* [2007] EWCA Civ 265, para 44)
 - But it is a relevant factor

E.U. / ECHR Right to Property

- E.U. Courts (under ECHR):
 - Non-assignable contracts with economic value are capable of being “possessions” such that the right to property applies (*Paeffgen GmbH v Germany*)



Performing Pre-Existing Contracts: What is Protected?



- Rights under a financial instrument to perform or receive performance in respect of obligations agreed prior to Brexit:
 - should constitute “possessions” under the E.U. Charter and ECHR and “acquired rights” as a matter of international customary law
 - will *a priori* be protected from public interference
 - Subject to E.U. Charter, Article 17(1): “...*except in the public interest and in the cases and under the conditions provided for by law, subject to fair compensation being paid in good time for their loss.*”
- Protections apply, in our view, to extant but unexercised rights, such as options:
 - including those that have been entered into but are not exercised pre-Brexit.
 - such contracts likely to be found to have economic value regardless of assignability.
- Good arguments that interference with lifecycle events under an existing contract would deprive the parties of the full value of their concluded contracts and thus infringe property rights:
 - Existing case law on agreements which contemplated future business did not deal with financial contracts

Justified State Interference?

- The E.U. right is qualified by the ability of a state to interfere with the right on certain permitted grounds in the public interest
- ECHR, Article 1: *“The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.”*
- Any interference in ongoing financial services contracts by a state would need to be *necessary or proportionate* to achieve a legitimate aim in the public interest

Justified State Interference?

- Arguments for interference:
 - Financial regulation designed to maintain integrity of the financial markets, preserve financial stability and protect consumers.
 - Regulation of U.K. (third country) service providers by an E.U. member state pursues a legitimate aim
- Arguments against interference:
 - Contracts were entered into in compliance with E.U. laws and regulation addressing such integrity, stability and consumer protection aims at the time – such concerns were addressed according to the law then in effect and can be prosecuted in respect of any failures at the point of sale.
 - U.K.-based party to a financial services contract with an E.U.-27 customer will continue to be regulated in the U.K., at least for the foreseeable future, under identical or very similar standards and by the same regulator, post-Brexit

Performing Pre-Existing Contracts

- ISDA Brexit FAQs published in September 2017:
 - Continued performance of pre-existing contractual obligations under ISDA standard form documentation for derivatives transactions would be unlikely to trigger authorisation requirements post-Brexit anyway
 - Continued performance does not constitute “the reception or transmission of orders”, “dealing on own account” or “execution of orders on behalf of clients” under MiFID because those activities will have taken place when the transaction was entered into, pre-Brexit
 - Such performance does not involve the provision or carrying on of any investment service or activity under E.U. or U.K. regulation
- Other contracts may suffer from contract law issues in terms of frustration risks due to regulation of ongoing performance activities, e.g.: i) administration or servicing of regulated mortgage contracts; ii) insurance claims handling; and iii) loan drawdowns
- Could trigger authorisation requirements in some E.U. member states
- But any state action preventing performance is then subject to human rights principles

Performing Pre-Existing Contracts: Relying on “Characteristic Performance” Test



- European Commission guidance states that the location of service is determined by reference to the “**characteristic performance**” of that service
 - Commission Interpretative Communication ‘Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive’, 20 June 1997 (SEC(97) 1193 final) and Commission Interpretative Communication on the Freedom to Provide Services and the General Good in the Insurance Sector (2000/C 43/03)

Performing Pre-Existing Contracts: Relying on “Characteristic Performance” Test (cont.)



- A service is deemed to be provided where the essential supply of the service for which payment is due takes place
 - Deposit-taking: takes place at the location of the branch where a bank’s books and records are kept
 - Fund management: occurs where the manager is located
- Note: not all E.U. member states have followed this guidance; query if they are in line with E.U. laws?
- Note: guidance is incomplete in its application to different financial sector activities
- EIOPA statement on ensuring continuity of services post-Brexit: largely ignores the point that Solvency II includes a cross-border test based on where the risk is located (in line with the Commission’s Interpretive Communication) and the type of insurance and reinsurance undertaken (e.g., for life policies, the risk is deemed to be located in the habitual residence of the life policy holder); instead refers only to the location of the policy holder and assumes local regulation.

New Agreements

- Contractual rights established after Brexit are not protected by human rights laws in the same way.
- Note: implications for booking models, netting and capital
- Difficulty of framework agreements: e.g. prime brokerage, ISDA master, clearing, custody, portfolio management, investment advisory
 - Need to ascertain whether the service provision is truly cross-border, including taking into account the characteristic performance test
 - Consider “reverse solicitation” (discussed below)
 - Is the actual performance really regulated if cross-border or just sales?
 - Contractual and legal entity structuring solutions may be needed

What will the E.U./U.K. do on this?

- European Commission (*Working Paper, 24 May 2017; Position Paper, 28 June 2017*) has accepted that it will permit goods lawfully placed on the single market to continue to be sold and made available after Brexit and that professional qualifications should continue to be recognised in the E.U.-27
 - So what about contracts and services?
- U.K. Government (*Philip Hammond, 20 December 2017*) will, “*if necessary*”, bring in legislation to ensure that contractual obligations which are not covered by the temporary permissions regime that the U.K. regulators are proposing to set up for non-U.K. firms, can continue to be met
 - Derivatives: Article 12(3) of the European Market Infrastructure Regulation protects the validity of OTC derivative transactions even in the event of an infringement of the Regulation

What will the E.U./U.K. do on this? (cont.)

- Precedent – the Euro:
 - E.U.-wide provisions introduced to ensure continued validity of contracts in already in existence (Article 3, Council Regulation (EC) No 1103/97 of 17 June 1997 on certain provisions relating to the introduction of the euro):
 - *The introduction of the Euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate such an instrument. This provision is subject to anything which parties may have agreed.”*

Self-help: Reverse Solicitation Solutions

MiFID II



- Recital 42 of MiFIR: *“Where a third-country firm provides services at the own exclusive initiative of a person established in the Union, the services should not be deemed as provided in the territory of the Union”*.
- Article 42 of the MiFID II Directive: allows third country firms to provide investment services or carry out investment activities without authorisation where a retail client or professional client established or situated in the EU initiates at its own exclusive initiative the provision of those services or activity
- Article 46(5) of MiFIR provides for the same for eligible counterparties

Self-help: Reverse Solicitation Solutions (cont.)

AIFMD

- Recital 70 states: *“This Directive should not affect the current situation, whereby a professional investor established in the Union may invest in AIFs on its own initiative, irrespective of where the AIFM and/or the AIF is established”*

National Laws and other guidance

- BaFin guidance on the German reverse solicitation exclusion for cross-border banking business and financial services: if a non-E.U. firm continues to inform its clients about its range of products within the scope of existing business relationships, this does not require a licence
- The mere fact that a website can be accessed by a customer located in an E.U. Member State does not necessarily imply that investment products on that website are being marketed or directed at such customers (Commission Communication 2017/C 218/02: European Commission guidance under PRIIPs)

Future-Proofing Existing Contracts

- **Assignability**
 - Inserting assignment clauses in existing and prospective contracts to preserve business continuity to the maximum extent
- **Reverse Solicitation**
 - Entering into contractual agreements before Brexit under which the service recipient expressly requests the service provider to carry out similar future activities and provide information about new or future products or services
 - Provides a path for servicing new business provided that additional structures are put in place
 - No numerical limit on number of clients!

Risk Factor

- Brexit may or may not happen and on that day there is a risk that cross-border contracts will end
- But it is OK because we have human rights laws. (These will apply to protect parties in many situations, as will laws on reverse solicitation, if you take action now to mitigate the effects of Brexit on contracts)
- However, there is no assurance that human rights laws will cover all contracts

Contractual Certainty on Brexit: E.U.-based Alternative for Cross- border Financial Services Contracts?

Sanjev Warna-kula-suriya, Latham & Watkins LLP

Objectives and Options

- Aim is to minimise uncertainty
- Helpful ways to move forward
 - Recourse to International Law
 - Contractual remediation
 - Restructuring of arrangements
 - Confirmation of continuity in the U.K. withdrawal legislation
 - Market “consensus”



Is there an E.U.-based Alternative?

- Precedent when European Monetary Union occurred in 1997 (Article 235 Regulation)
 - Different political context but consistent with published E.U. approach to pre-withdrawal date; (a) goods placed on market and (b) governing law/jurisdiction in contracts
- Is a new E.U. Regulation feasible?
 - Procedural and timing challenges
- A clause in the Withdrawal Agreement?
 - *Vires?* (Commission v Council)
- An “extension” to existing financial services directives?
 - Can the Commission grant this?

Thematic Summary

Lord Thomas of Cwmgiedd, FMLC Chairman