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Brexit and Other Key Issues for CFOs and Corporate Treasurers

What Has Happened?

Brexit

On June 23, 2016, the UK electorate voted to leave the European Union in an advisory Referendum. We expect the UK Government to commence negotiations to withdraw and to establish a framework for the UK's new relationship with the EU and its other trading partners. Exit is expected to be in September 2018 at the very earliest.

The Brexit vote has had an immediate impact by triggering significant volatility in the financial markets and the UK's sovereign credit rating dropped to AA/Aa1. Companies have had to respond quickly. The shape of the future relationship between the UK and the EU, which is currently subject to much speculation, will determine the future impact of Brexit, but companies are making contingency plans.

US Tax Changes

In addition, on April 4, 2016, the US proposed regulations under section 385 of the Internal Revenue Code (the "Proposed US Tax Regulations") which would reclassify certain related party debt transactions as stock for US tax purposes. If and when the Proposed US Tax Regulations are finalized, payments on a debt instrument issued by a US subsidiary to its non-US parent or a debt instrument issued by a non-US subsidiary to its US parent will be taxed as dividends if the instrument is reclassified as equity. In that circumstance, the payments would not be deductible by the payor for US tax purposes and could become subject to a higher rate of US withholding tax if the payments are US source income. Any reclassification of an instrument as equity would apply for all US tax purposes, and, therefore, the reclassification could have many other material adverse tax consequences for multinational groups. Some provisions of the Proposed US Tax Regulations would apply to debt instruments issued after April 4, 2016. Thus, instruments issued between related parties today could become subject to the Proposed US Tax Regulations after they are finalized even though the Proposed US Tax Regulations are not yet final.

What Now?

Management teams of groups with UK companies or UK trade are now assessing and prioritizing the risks and potential opportunities that Brexit introduces and reviewing their budgets. They are also considering whether to make changes to their corporate organization and funding structure in response to the Proposed US Tax Regulations to avoid adverse tax consequences.

This client note sets out a number of near-term practical considerations for CFOs and Corporate Treasurers arising from Brexit and the Proposed US Tax Regulations. We also attach a summary checklist of considerations.

We have also published a client note addressing Brexit issues in greater detail, "**Brexit: What Does the Vote mean for Business**,"[1] and a client note on the Proposed US Tax Regulations, "**Proposed Regulations on Related-Party Debt Instruments: Would Result in Dramatic Adverse Tax Consequences**."[2]

We have a unified US, UK and Continental European team available to assist clients with an integrated solution tailored to their individual circumstances for companies facing the complex challenges arising from Brexit and the Proposed US Tax Regulations.

Immediate Considerations

What Immediate Impact Could Current Currency Volatility Have Under Financing Arrangements?

Changes to mark to market values as a result of currency volatility may require an immediate response. The changes may trigger requirements to post collateral or increase credit lines to obtain more hedging. Companies may also wish to review cash pooling and other treasury arrangements which automatically convert dollars and other currencies into euro and sterling.

Many companies will shortly face financial covenant or other financial tests by reference to their June 30 financial statements. Compliance may be affected if the company's debt in foreign currencies is calculated by reference to the spot rate at June 30 rather than an average rate. Companies may also seek to adjust their covenants to mitigate the impact of future mark to market movements or the costs of restructuring or contingency planning.

The fall in sterling and the euro may also impact financial limits in financial documentation or corporate authorizations or investment documentation. For example, thresholds for incurring debt or making disposals or acquisitions may be tied to sterling or euro rather than the dollar and it may be necessary to raise these thresholds to reflect the fx rate when the agreement was entered into or some other agreed basis. Some facilities may be tied to asset valuations of UK or EU assets in dollars (which have fallen). Other facilities (such as dollar letter of credit facilities) may be rebased periodically by reference to a base currency in euro or sterling and the change in currency may trigger a requirement to make a prepayment or provide cash collateral or agree more headroom going forward.

Downgrades of the UK and banks may also have an impact, for example, where companies are required to provide bonds from, or hold cash collateral with, banks with a minimum credit rating.

How Will Brexit and the Proposed US Tax Changes Affect Financing Structure and Treasury Functions?

Multinationals with sophisticated European corporate structures utilizing intragroup financing and/or cash pooling arrangements may wish to review the potential for tax leakage on repatriation of cash for debt service, dividend payments and other purposes. Tax leakage is likely to occur as a result of the Proposed US Tax Regulations in some corporate groups. Corporate reorganizations required to mitigate the position could also include some Brexit proofing steps.

Whether there will be increased tax leakage on the repatriation of profits between UK and EU companies as a result of the UK exiting the EU in the future will depend on whether or not the existing withholding tax arrangements between the UK and other companies within the EU are preserved as part of the deal reached

[1] http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/06/Brexit__The_Result__Client_Note_FIA062416.pdf

[2] http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/06/Proposed-Regulations-on-RelatedParty-Debt-Instruments-Would-Result-in-Dramatic-Adverse-Tax-Consequences-TX-060316.pdf

between the UK and the EU. For instance, absent a full withholding exemption in the relevant bilateral tax treaty, EU subsidiaries of UK parent companies (potentially including those in Austria, Germany, Greece, Italy and Portugal) may in the future be required to withhold tax on dividends paid to their UK parent. Conversely, EU companies may incur an increased tax charge on dividends received from a UK subsidiary. Interest payments on intra-group loans between UK companies and certain EU companies (such as those in Italy and Portugal) may also be subject to withholding tax, again depending on the terms of the relevant tax treaty.

However, the UK has relatively low corporate tax rates, and may introduce further tax incentives for businesses which may provide opportunities to develop more efficient structures using the UK, so it is worth having flexible contingency plans.

We suggest that financing documentation be reviewed to check for any impediments to a corporate reorganization (such as requirements to maintain residence or other restrictions) and other restrictions on early prepayment, transferring or disposing of assets, cash extraction or the incurrence of debt. Similarly, any tax gross-up clause and withholding rules in the borrower jurisdiction should be reviewed.

Could Lenders Refuse to Fund Under a Commitment Letter Signed Prior to the Brexit Vote for an Upcoming Financing Because There Was a Leave Vote?

Whether lenders can refuse to fund under an open commitment depends on the specific wording of the commitment letter. We would not generally expect that the vote would trigger a material adverse effect/material adverse change, termination event or force majeure under market standard English law commitment documentation. However, some commitments entered into prior to the Brexit vote included provisions (flexits) allowing upward changes to the pricing and other changes to be made following a leave vote. It is also important to check documentation to make sure there are no conditions a lender could use to avoid funding.

Could the Brexit Vote Cause a Drawstop or Termination Event Under an English Law Loan Agreement?

Whether a Brexit vote causes a drawstop or termination event under an existing English law loan agreement will depend on the wording of the loan agreement. However, generally we would not expect that the vote itself would cause a drawstop or termination event. The market volatility may lead to a failure to meet financial tests or asset values or make prepayments. In the future, a borrower’s business could be impacted when the UK exits through the loss of a key EU-wide license or authorization should EU-wide arrangements cease to apply and this may trigger a termination event. This could be a particular risk in industries which are highly regulated in the EU, such as financial services, life sciences, energy and transport. It is also possible that companies will not be able to obtain hedging to meet contractual requirements on terms that they consider acceptable. Future loan agreements may start to contain provisions tailored for Brexit.

Will Brexit Have Consequences for Derivatives Documentation?

We would not expect that the Brexit vote itself will have triggered a termination event or event of default under an International Swaps and Derivatives Association (ISDA) Master Agreement but the specific terms negotiated should be reviewed. It is possible that in the future some banks may wish to use subsidiaries or branches within the EU as counterparties to derivatives contracts and may also look to make some amendments to ISDAs for this or other Brexit related matters. In due course, companies may also want to consider what flexibility they need under their ISDA documentation to reorganize corporate groups and treasury arrangements and transfer derivatives, including under the provisions relating to mergers and tax events.

Near Term Considerations

Will the Brexit Vote Make it More Difficult to Raise Finance for European Businesses in the Near Term?

Lenders may have less appetite to lend in sterling or to companies with significant UK business. Pricing is increasing and tenors may shorten and we expect deals to take longer. It will be difficult for companies and finance providers to assess budgets and projections until more information is available on the deal the UK and the EU are likely to reach. There may also be a dampening effect on lending to businesses in continental Europe but it is early days. Capital markets issuance in Europe in the run up to the Brexit vote has been light and the capital markets are expected to remain choppy. Companies may use techniques used during the market dislocation following the financial crash, such as raising incremental debt under uncommitted lines or through tap issues under existing finance documentation or to amend and extend existing financing rather than to attempt a full refinancing. Companies may wish to review their financing documentation to check for flexibility to amend and extend their facilities and/or incur more debt.

European companies may choose to raise finance in the US (providing hedging costs are cost-effective) or from the many non-bank alternative lenders that have emerged following the financial crash.

The Bank of England has indicated it will keep interest rates low in the near future and the current market conditions may present opportunities to make acquisitions at favorable pricing or to do debt buybacks below par and other liability management.

Will Brexit Affect My Choice of Relationship Lending Banks?

At present, corporate loans to companies in the UK and some other EU member states can be made by entities without a banking license. However, certain loans to borrowers in some EU member states can only be made by a lender regulated there or a lender regulated in another EU member state which has a “passport” to lend to companies in countries within the EU. Absent a negotiated post-Brexit arrangement, non-EU lenders, such as US banks lending to EU borrowers from UK branches or subsidiaries, may no longer be able to continue to make loans to companies in certain EU member states. Under standard documentation, a lender is usually required to take steps to mitigate the position by transferring the loan(s) to another branch, affiliate or another lender, failing which a borrower may be required to repay the portion of any loan provided by the lender.

We expect that many banks, including US and UK banks, will make contingency plans so that they will be able to continue to lend to borrowers in the EU, possibly by transferring the loan to an affiliate in the EU. We suggest that companies in affected EU jurisdictions discuss contingency plans with their lenders and ensure they will be involved in any decisions by lenders to restructure loans and build in flexibility to restructure lending arrangements before loans become repayable.

Loans and grants by the European Investment Bank and other EU bodies to UK companies may become repayable on Brexit unless transitional arrangements are agreed because it is often the policy of such bodies not to lend to entities outside the EU.

Companies may like to check their loan agreements, in particular gross-up, increased costs and transfer provisions, to see to what extent banks can pass on the cost of any regulatory change or make transfers to affiliates as a result of Brexit.

What Public Disclosure, if any, Should Be Made in Light of the Brexit Vote? Can I Speak with Securities Analysts?

In light of the economic and political impact of the Brexit vote, both on the UK and the EU, securities regulators will be focused on how companies with a significant nexus to those jurisdictions evaluate and discuss any potential material impact on their business. Public companies should evaluate the potential impact of the UK's exit from the EU and consider whether their risk factors and forward-looking statements adequately address the circumstances to date. To the extent companies have not already done so, it is advisable to consider including a general risk factor relating to the impact of the Brexit vote on economic conditions or more specific risks about how a potential withdrawal of the UK from the EU and any follow-on effects might impact their particular business in the UK and the EU. In our previous client note, we provided suggested drafting for such a risk factor. See our client note "**Brexit Q&A: Business Implications**."[3]

Getting ahead of analysts' questions about the impact of the Brexit vote may make sense for companies with operations in the UK or Eurozone. Companies that wish to do so should be mindful of avoiding selective disclosure and should evaluate whether any part of the proposed discussion could be considered material non-public information. If so, they should consider issuing a press release or current report so that the information is broadly disseminated to comply with the applicable disclosure rules (including Regulation FD, if applicable) and as a best practice.

Will I Still Be Able to Offer Securities in the EU?

For most US corporates, accessing either the UK or the EU capital markets should remain relatively straightforward.

For US corporates that wish to continue to offer their securities in the UK, we do not foresee Brexit creating material additional regulatory burdens for doing so. The existing requirements are reasonably straightforward and we perceive no impetus for changing that.

US corporates accessing EU capital markets (apart from the UK) generally do so on an exempt basis and we do not anticipate this approach changing as a result of Brexit.

For those US corporates that carry out non-exempt EU securities offerings within the EU (other than the UK), there is an open question as to how much of an additional burden may be imposed by the European Securities and Markets Authority post-Brexit when it reviews a prospectus drawn up under UK rules. We examined this issue in greater detail in our previous client note.[4]

Should I Expect Significant Changes in Documentation Relating to Equity and Debt Offerings Due to the Brexit Vote?

We do not expect significant changes in documentation relating to equity or debt offerings. We do expect, however, to see underwriters adding questions concerning the impact of the Brexit vote on issuers to their due diligence questionnaires and expect them to conduct due diligence on Brexit related risk factors, particularly for companies with significant business in the UK or the Eurozone.

Do I Need to Change my Financing Agreements Before Brexit Happens?

It is likely that some financing agreements will need to change before the UK exits the EU whichever law governs them. This is because there may be references to the EU territories, regulators and laws that will no

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[3] http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/06/BrexitWhatDoestheVoteMeanforBusinessFIAFR062816.pdf

[4] http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/06/BrexitWhatDoestheVoteMeanforBusinessFIAFR062816.pdf

longer include the UK. For example, if a borrower is permitted to conduct activities so long as they are in the EU, the permission would need to be extended to the UK post-Brexit. We recommend a review of financing agreements to identify such issues.

Should I Continue to Use English Law for my Financing Arrangements?

We believe that there will generally be no compelling reason to switch from English law as a result of Brexit and this is covered in more detail in our earlier client publication.[5] The UK will withdraw in accordance with an orderly process maintaining certainty of law rather than the emergency exit threatened by Greece in recent times. English law and New York law are the "common denominator" for financing agreements used throughout the world.

Under EU law, the courts of EU member states are required to respect the choice of law made by the parties to a contract, whether it is New York law, English law or another law.

Nearly all high yield bond documents entered into by European issuers and many other financing agreements for European financings are governed by New York law and contain a New York law jurisdiction clause although there is no special deal between the US and the EU for recognizing choice of law or enforcing judgments. The use of New York law for European financings is not generally considered to present any material legal risk. If arrangements between the UK and other parts of the EU for fast track enforcement of judgments do not continue post-Brexit, contracts governed by English law and containing English jurisdiction clauses would be treated in the same way by the courts of an EU country as contracts governed by New York law and containing New York law jurisdiction clauses.

If there is a particular concern with enforcement of a judgment on a contract, then we recommend that specific legal advice is taken and a decision is taken on the choice of courts or even arbitration following that advice.

Market standard loan documentation exists for syndicated loans governed by French, Spanish and German law, although this is typically used for smaller local deals where the borrower is in France, Spain or Germany.[6]

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5 http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/06/BrexitWhatDoestheVoteMeanforBusinessFIAFR062816.pdf

Checklist for Brexit and Proposed Changes to Related Party Debt Instruments

Financing Structure/Treasury Function

- Consider corporate restructuring to avoid tax leakage (including relating to the Proposed US Tax Regulations)
- Check financing documents for ability to extract cash, dispose of assets, incur debt and early prepay

Currency Volatility

- More collateral required?
- Increase of hedging lines required?
- Review whether facilities rebased periodically in a base currency exceed thresholds and require more headroom/prepayment
- Review automatic cash pooling currency conversion
- Review financial covenants/tests
- Review requirements for minimum credit rating for bonds/cash collateral
- Review thresholds in finance and investment documentation or corporate authorizations measured by reference to sterling/euro amounts or asset values
- Brexit Vote should not trigger MAC/material adverse effect, termination event or force majeure, but wording should be checked
- Review potential impact of currency volatility/existing hedging on existing guidance

Open Commitments

- Review commitment documentation for conditions that may allow lenders to decline to lend and "flexit" provisions allowing changes to pricing, etc.
- Review price adjustment and earn out provisions in acquisition agreements
- Brexit Vote should not trigger MAC/material adverse effect, termination event or force majeure, but wording should be checked

Loan Agreements

- Review for potential future Brexit impact and ability to do a corporate restructuring, disposal, acquisition and/or raise more debt
- Brexit Vote should not trigger MAC/material adverse effect, termination event or force majeure but wording should be checked but subsequent impact of Brexit on loss of licenses or trading arrangements may do

Derivatives

- Brexit Vote should not trigger a termination event or event of default, but wording should be checked
- Consider flexibility for company or financial institution to transfer the derivative in the future

Financing Requirements

- New financing may take longer and be more expensive/shorter tenor. Consider flexibility in finance document to raise incremental debt and to amend and extend. Consider US markets (subject to hedging) and alternative lenders
- Consider debt buybacks and other liability management

Changes to Finance Documents for EU Terms

- Review finance documents for references to EU territories, regulators or laws (e.g., restrictions on activities unless within the EU may need to be extended to the UK)

Equity and Debt Offering Documents

- Underwriters may add due diligence questions on Brexit impact and require more Brexit related due diligence

Choice of Law and Courts

- Review, but no need to change from English law in most cases (see above)

Relationship Banks

- If a bank in London lost its EU passporting it may need to transfer to an EU affiliate to carry on lending. Discuss with banks
- Check gross-up, increased costs and transfer provisions in loan agreements

EU Funding

- Finance from European Investment Bank and other EU bodies to UK companies probably repayable on Brexit

Disclosure by Public Companies

- Consider Brexit risk factors and company reporting, including impact on existing guidance and consolidated impact of Proposed US Tax Regulations on financial reporting

Offering of Securities in the EU by US Companies

- US corporates carrying on non-exempt EU securities offerings may face additional prospectus requirements

Some Other Matters Depending on the EU's Deal with the UK

- Existing commercial contracts should be reviewed for the impact of Brexit, including any economic impact of paying additional duties or tariffs
- There may be restrictions on UK workers working in the rest of the EU and EU workers working in the UK, although grandfathering is expected. HR departments will need to plan
- EU-wide regimes may cease to benefit UK companies, such as EU wide licenses, authorizations and trade marks and UK equivalents may be also needed
- Consider supply chain issues: UK manufacturers shipping goods to the rest of the EU may face supply chain disruption (border controls, customs duty, tariff payments, more complex VAT compliance)
- If the UK does not negotiate access to the single market, trade tariffs will likely apply to trading with the EU
- The UK may also lose access to the markets of other non-EU countries under free trade agreements to which the EU is party and will need to negotiate its own deal
- The UK is likely to try to negotiate access to the single market though
- Transfer of personal data from the EU to a non-EU country must comply with EU rules, so UK companies may need to continue to comply with EU data protection rules although some exceptions may apply to BPO
- Customers and suppliers may be affected by Brexit and may want to know what the effect will be on you
- EU grants and also emissions allowances from the EU Emission Trading System will no longer be made available to UK companies
- UK companies may no longer be able to participate in some public procurement processes (a) in other parts of the EU or (b) in non-EU countries pursuant to free trade agreements to which the EU is party. Consider restructuring to utilise EU companies instead

CONTACTS

George A. Casey
New York
+1.212.848.8787
gcasey@shearman.com

Lawrence M. Hill
New York
+1.212.848.4002
lawrence.hill@shearman.com

Lisa L. Jacobs
New York
+1.212.848.7678
ljacobs@shearman.com

Joshua W. Thompson
New York
+1.212.848.8703
joshua.thompson@shearman.com

David Dixter
London
+44.20.7655.5633
david.dixter@shearman.com

James Duncan
London
+44.20.7655.5757
james.duncan@shearman.com

Apostolos Gkoutzinis
London
+44.20.7655.5532
apostolos.gkoutzinis@shearman.com

Jeremy Kutner
London
+44.20.7655.5743
jeremy.kutner@shearman.com

Caroline Leeds Ruby
London
+44.20.7655.5944
cleedsruby@shearman.com

Simon Letherman
London
+44.20.7655.5139
simon.letherman@shearman.com

Frank Miller
London
+44.20.7655.5904
frank.miller@shearman.com

Barney Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

ABU DHABI | BEIJING | BRUSSELS | DUBAI | FRANKFURT | HONG KONG | LONDON | MENLO PARK | MILAN | NEW YORK
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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

9 APPOLD STREET | LONDON | EC2A 2AP | UNITED KINGDOM

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