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Brexit - Flexit Clauses

There has been plenty of commentary about how the Brexit debate is impacting corporate, commercial, finance and real estate transactions. In the media there have been reports of “market jitters” surrounding the possibility of a Brexit. The British Property Federation and other trade bodies have reported delays in investment and development decisions due to uncertainty in the lead up to the Referendum. Transaction volumes are down. Where assets are changing hands or companies are being sold or banks are agreeing to lend, the question of “what if” is inevitably an important factor.

A consensus seems to be developing that a Brexit may not constitute an event of default under certain types of contract, for example, LMA loan agreements, as they operate primarily by reference to the financial condition of the borrower or the borrower’s group rather than by reference to financial market conditions. Nonetheless, many people are questioning how they can minimise the impact of a Brexit on their business. The following areas highlight some contingency planning worth considering in the run up to the Referendum.

Material Adverse Change (MAC) Clauses

It is not unusual in commercial contracts to include a force majeure or MAC clause. Parties should consider whether they can rely on a non-specific clause of this type, especially if they were aware of the possibility of Brexit when entering into a transaction. With organisations looking to protect their position in the event of a “leave” vote, we are seeing specially-developed MAC clauses appear in contracts.

Parties have been looking to include specific terms in new contracts which deal with the possible consequences of a Brexit. A crucial consideration is whether contracts can be terminated, at the option of one or other party, as a result of a Brexit. Such a termination right is best drafted as an express term, it should contain suitable notice provisions, and potentially it may provide for the detailed consequences of exercise of the right.

A potential difficulty with drafting such a clause would be defining “Brexit”, and deciding whether the trigger should be a vote to leave the EU or some later event (e.g. what happens if the vote to leave leads to another round of negotiations with the EU and a further referendum).

Interpretation of existing contracts

Questions have arisen about how to interpret existing contracts if there is a vote for Brexit. Do existing force majeure clauses come into play and what is their effect? There could also be uncertainty surrounding the effect of an English governing law clause. English contract law is largely judge-made and is likely to remain fundamentally unchanged. But in some areas, English law, directly or indirectly, includes concepts, rules and regulations which emanate from the EU, and a Brexit would lead to change. It is likely that English governing law clauses would be interpreted to mean English law as it exists from time to time. Particular difficulties can be envisaged where a specific EU provision is an essential part of a contract, or rights exist which are heavily dependent on EU concepts and thinking, or even where there are express references to the EU or EEA.

Increased costs

One possible effect of Brexit could be to increase costs. Parties to a contract (such as banks) often have the right to pass on the costs of regulatory change to the borrower. They may not invoke that right for relationship reasons but there is a possibility that the regulatory effect of Brexit could have an impact on the costs of lending for UK and overseas banks. This is an area that requires attention.

Choice of jurisdiction

Generally, EU regulation gives effect to a contractual clause choosing the English courts by recognising that court's jurisdiction and requiring any other EU court to decline or stay proceedings in their jurisdiction. If the UK were to leave the EU and withdrawal negotiations resulted in these regulations ceasing to apply, the English courts would continue to accept jurisdiction on the basis of the parties' choice. However, other courts may not so readily respect that choice.

Next steps

Whilst many organisations are deferring transactions until after the Referendum, those who wish to proceed should be alert to the above issues when considering "flexit" provisions as a risk mitigation package. There will also be other issues. All of these potentially introduce an additional dimension to transactional negotiations upon which legal advice should be taken. K&L Gates is advising on the negotiation and drafting of such provisions in a range of contracts.

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