BREXIT

IMPLICATIONS FOR M&A AND PRIVATE EQUITY FUNDS

The UK's unprecedented vote to exit the European Union has created a great deal of business and legal uncertainty. Practical Law asked leading practitioners to share their views on the potential implications of Brexit for M&A activity and private equity funds.

On June 23, 2016, in a historic country-wide referendum, the UK voted to leave the European Union (EU). The UK is now expected to begin the formal process to exit the EU and to establish new regulatory and legal relationships with the EU and its member states.

The Brexit vote marked the start of what is expected to be a long and complicated exit process. Article 50 of the Treaty on European Union allows an EU member state to give irrevocable notice of its intention to leave the EU. Public statements from new Prime Minister Theresa May's government indicate that the UK currently plans to deliver the Article 50 notice in early 2017. After delivery of the notice, there is a two-year period for the UK and EU to negotiate a withdrawal agreement. The two-year period can be extended by mutual agreement, but if there is no agreement and no extension, the UK would cease to be a member of the EU after the two-year period.

As of press time, the nature of the UK's relationship with the EU post-Brexit is unclear. If no withdrawal agreement is reached, the UK would likely be in the position of trading on a World Trade Organization-basis. If a withdrawal agreement is reached, it is expected to be based on one of three alternatives:

- The Norway model, where the UK becomes a member of the European Economic Area (EEA) and European Free Trade Area (EFTA).
- The Switzerland model, where the parties negotiate a series of bilateral agreements.
- The Canada model, where the parties negotiate a comprehensive free trade agreement.

Because no EU member state has ever withdrawn from the EU, Brexit has created a great deal of uncertainty. Practical Law asked leading practitioners about Brexit and what companies and investment funds should be considering after this unprecedented vote. *Richard Hall* of *Cravath, Swaine & Moore LLP* discusses the impact on public M&A, *Ben Perry* of *Sullivan & Cromwell LLP* discusses the impact on private equity M&A, and *Christopher Leonard* of *Akin Gump Strauss Hauer & Feld LLP* discusses the impact on private equity funds.

PUBLIC M&A

RICHARD HALL
PARTNER
CRAVATH, SWAINE & MOORE LLP

Richard is a partner in the firm's Corporate Department and is Head of the Mergers and Acquisitions practice for EMEA. His practice focuses on mergers and acquisitions, corporate governance advice, and matters relating to activist defense.

Richard discusses the potential impact of Brexit on public M&A, including the implications for transaction structures and changes in the regulatory environment:

How do you expect the Brexit vote to affect strategic M&A activity?

The Brexit vote, and the actual process for the UK's exit from the EU, will have a negative effect on global strategic M&A activity. However, I expect that effect will play out differently over various time periods and across various geographies, depending on the nature of the strategic M&A activity.

What do you think will be the short-term impact on strategic M&A activity?

The result of the Brexit vote came as a surprise to many people in the business community, as reflected by the immediate currency and stock market declines. That volatility had a swift negative effect on strategic M&A activity, as dealmakers stepped back and "took a deep breath." However, the initial shock seems to have dissipated.

We are now seeing recognition that the UK, at least under Prime Minister Theresa May, has determined that "Brexit means Brexit" and will head down the path of exiting from the EU. Strategic dealmakers will, for a period of time, be facing a very uncertain future. Nobody knows now what the UK and the EU will look like following Brexit.

From a political perspective, one of the interesting contrasts between the "remain" and the "leave" campaigns is that those who voted to remain were broadly in agreement as to what remain meant. On the other hand, it is now clear that those who voted to leave were not aligned on what leave actually meant. Since the Brexit vote, some leading Brexiteers have advocated that the UK take advantage of Brexit to implement a more open, deregulated economic agenda, while others have proposed a more closed system.

Until there is clarity as to the meaning of leave, regardless of whether that looks like the Norway model (EEA membership), the Switzerland model (bilateral agreements), the Canadian model (free trade agreement), or some other unique model, it will be more difficult to execute strategic M&A transactions that are connected to the UK or the EU.

Do you think the impact on strategic M&A will be more significant than on other types of M&A activity?

I believe the negative impact on strategic M&A activity from Brexit will be different from the impact on sponsor-driven M&A. A strategic M&A acquiror should take a long-term view of the value to be created from a proposed transaction. For this reason, the long-term uncertainty created by Brexit is likely to weigh more heavily on the minds of strategic dealmakers.

Will some industries be more significantly affected?

I expect the biggest impact of Brexit will be on UK-focused businesses, primarily those in the financial services, real estate, and construction sectors.

What do you think will be the long-term impact of Brexit?

I expect the most significant long-term impact on strategic M&A from Brexit will be its effect on economic growth within the UK and the EU. As noted above, the precise scope of leave remains to be established. Almost certainly, however, it will include some measure of uncoupling the UK from the economic unit that is the EU.

There is no doubt that the inclusion of the UK within the common market area of the EU over the last 20 years has had a significant, and on balance favorable, impact on the economic performance of both the UK and the EU (excluding the UK). Even with this favorable impact, however, both the UK and the EU have struggled to recover from the global financial crisis.

The EU was the UK's largest export market, and the UK was the EU's largest external supplier of a range of goods and services. The loss of economic stimulus on both sides of the English Channel caused by that uncoupling will challenge the two economies, likely adversely affecting both the economic performance of businesses that are located in or focused on those two areas and, ultimately, strategic M&A activity in both the UK and the EU.

A related point, again, is the adverse effect on strategic M&A of the uncertainty associated with the long-term economic effect of Brexit. Even if a strategic dealmaker is confident in the directional impact of Brexit on the valuation or attractiveness of a particular asset, the size and timing of that impact, and the implications of possible ameliorative actions, are all uncertain. This combination of uncertainty does not create a favorable environment for strategic M&A.

How will Brexit affect opportunistic buyers? Will there be some cheap assets for sale?

There certainly will be assets for sale at reduced prices, particularly in US dollar terms. However, if Brexit has caused a particular business to become available for purchase at a lower effective price, I expect that many strategic acquirors will be concerned that Brexit has caused the business fundamentally to be less valuable. Until some of the uncertainty about Brexit has been removed, I do not expect strategic acquirors from outside the UK and the EU to show significant enthusiasm for acquisition opportunities in the UK and the EU simply because they have suddenly become cheap.

Brexit seems to have led to a further dip in interest rates. Will this spur strategic M&A activity?

I do not think the recent decrease in interest rates will lead to an increase in strategic M&A activity. Interest rates have been low for quite a while, and the cash acquirors that want to exploit the favorable interest rate environment have had plenty of time to do so.

How will Brexit affect European companies? Will they be looking to expand internationally?

Absolutely. However, as discussed above, the UK and the EU have struggled to recover economically following the global financial crisis. As a result, many strong European companies have been looking for substantial acquisitions outside the EU for several years in a search for growth outside their home markets. The potential adverse consequences of Brexit may encourage those companies to look harder and perhaps bid more aggressively, but I do not believe they will pursue opportunities that would not have otherwise been attractive to them pre-Brexit.

There are also many substantial European companies that generate the bulk of their revenue outside the UK and the EU. These companies will be less affected by Brexit in their underlying business operations. As such, I expect these companies, both as strategic acquirors and as potential targets, to be less affected by Brexit than those European companies with an operational focus on the UK and the EU.

Will the adverse effects of Brexit be limited to public M&A? Are there different considerations for private deals?

The adverse effects caused by the uncertainty and the expected economic slowdown in the UK and the EU should affect both public and private M&A. As a practical matter, smaller and private companies in the UK and the EU are less likely to be diversified internationally and therefore are more likely to be adversely affected by these developments.

Do you anticipate any changes in the regulatory environment?

One of the many areas of uncertainty relating to Brexit is when, how, and to what extent the UK extricates itself from the substantial system of EU law under which it has operated for many years. In the area of strategic M&A, one obvious question is antitrust merger clearance. It seems likely that, in a post-Brexit world, the UK's stand-alone merger control regime will have review authority over transactions that would have otherwise been subject to clearance solely in Brussels. This will make strategic M&A more complex and more expensive.

In addition, it is likely that the UK will cease to benefit from the "passporting" system relating to the offering of shares across the EU. This will also make public, share-for-share business combinations involving UK and EU companies more difficult and expensive.

These transaction-related changes in the regulatory environment simply reinforce the greater uncertainty about the overall business and legal environment in the UK in a post-Brexit environment. Many UK businesses, and global businesses with operations in the UK, have come to rely on the harmonization of UK and EU law across a wide range of areas. If a US technology company is based in Ireland, as a general matter it knows that if its data privacy practices work in Dublin, they will work in London. This is also true for intellectual property and employment practices, among other practices. In the post-Brexit world, it remains to be seen whether some enterprises will lose the legal basis for profitable business models or whether new models will become available. We just do not know at this time.

Do you expect many current transactions to founder?

No. The Brexit vote had been on the radar for months. Dealmakers had already decided how they would deal with a Brexit vote well before June 23, 2016. Some potential transactions were not signed earlier in the year because of Brexit risk, but I expect those transactions that signed will close.

Do you anticipate any changes in transaction terms?

I do not expect to see any immediate and significant change in transaction terms. As we approach the due date for Brexit, however, and we have greater visibility into the political choices being made within the UK and the EU regarding the post-Brexit world, we should start to see specific Brexit-related provisions dealing with specific risks. I expect this will be more prevalent for transactions that are focused in the UK and also more prevalent for transactions in industries that are most significantly affected by Brexit, such as financial services.

This issue will also become more important as the UK develops its overall approach to the post-Brexit application of general EU business law, including in areas such as employment law, contract terms, and data privacy. It is hard to imagine that the UK will simply wind the clock back 40 years on all these laws, which are woven into the fabric of UK commerce. Equally, however, it is unlikely the UK will not take advantage of post-Brexit flexibility to eliminate at least some of these laws. As the due date for Brexit approaches, I would not be surprised if strategic dealmakers for UK businesses begin to focus on narrow "change in law" risks.

One very sensitive area will be tax law. Over the last several years, the UK approach to international tax has shifted significantly. This has created substantial flexibility for corporations in setting up internal corporate structures and for dealmakers in structuring transactions. While most of the UK tax system is independent of the EU, Brexit could provoke critical changes in UK tax policy and raise concerns about "change in tax law" risks.

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One area of immediate concern is the impact of Brexit on the choice of English law and forums for dispute resolution. For several years, English law and either English courts or London arbitration have been the most common package for dispute resolution in cross-border private M&A in Europe. With an impending UK exit from the EU, however, we may see a shift away from English law and courts as the preferred model for both political and technical legal reasons.

Do you expect an effect on transaction structures?

One likely immediate impact on transaction structures arising from the Brexit vote is a reduction in the use of UK companies as a neutral third jurisdiction in cross-border merger transactions. I expect heightened concern about the selection of the UK as a jurisdiction of incorporation of convenience, in part because of the uncertainty generated by the impending UK exit from the EU, as well as long-term concerns about matters such as the UK's immigration and tax policies.

Cross-border transactions involving UK companies will also likely lose the so-called "European cross-border merger" structure. This has been infrequently used by UK companies, so its loss is not likely to have any significant impact.

Cravath, Swaine & Moore llp