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BREXIT – where next?

"…Alea iacta est…" (The die is cast)

Julius Caesar, 49 BC, on crossing the Rubicon.

Introduction

When Julius Caesar was removed from his command by the Roman Senate in 49 BC, he uttered "*Alea iacta est*" (the die is cast) and crossed the Rubicon river with his troops. This step was naturally illegal under Roman law and Caesar thereby irrevocably committed himself to an act of rebellion. As a result, the phrase reproduced above is generally taken to refer to a step that will set in train an irreversible chain of events. At a later stage, Caesar met his ultimate fate at the hands of Brutus and other conspirators, on the Ides of March.

Some 2,000 years later, David Cameron's Rubicon moment came on 20 February when, on returning from the negotiation of a new settlement with other EU Member States, he announced a firm date for a referendum on the UK's continued membership of the EU. Matters proceeded inexorably from there, until David Cameron encountered his own Ides of March on the morning of 24 June through the referendum's ***"Out"*** vote. On this occasion, the conspirators were Boris Johnson, Michael Gove, Nigel Farage and sundry others—the outcome may have been less bloody but the consequences promise to be cataclysmic.

In the earlier stages of the referendum campaign, we put out two briefings on the consequences of Brexit, both for the UK itself and for businesses operating here. Obviously, there have been few substantive developments since the referendum result was announced on 24 June but – now that the Brexit die is cast – this seems to be an appropriate moment to reassess the current situation.

The withdrawal process

At the outset, it may be helpful to provide an overview of the UK's position in relation

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to the process of withdrawal from the European Union. There are two aspects to this process.

Firstly, the EU Treaties govern the termination of the UK's membership.

At the highest level, the process is governed by Article 50 of the Treaty on European Union. The salient provisions of that Article read as follows:

"…Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements…. A Member State which decides to withdraw shall notify the European Council of its intention…."

"…In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union…"

"…The Treaties shall cease to apply to the State in question from the date of entering into force of the withdrawal agreement or, failing that, two years after the notification [of the Member State's intention to withdraw from the Union] …"

It is perhaps understandable that these provisions are written in fairly open-ended terms and do not go into great legal detail, for the circumstances giving rise to the departure of a Member State could be many and varied. But Article 50 has already created a source of contention. David Cameron has announced that he will resign as Prime Minister in October, following the appointment of his successor. He also announced that the timing and delivery of the Article 50 notification to the European Council would be determined by that successor. From the perspective of the UK, this is an understandable position. If the Article 50 notice were given now, then the two-year negotiation period would begin to run. These negotiations may be critical for the future of the UK's economy and it would be inappropriate for them to begin under the aegis of an outgoing Prime Minister who supported continued EU membership. In addition, it will no doubt be necessary to assemble a substantial negotiating team, and they would wish to have adequate time to prepare their positions before engaging with EU institutions. It may also be that a period of delay would allow tempers to cool, and provide for a period of informal pre-negotiations that may smooth the path at a later stage (although the EU side has indicated that no negotiations can begin until the Article 50 notice is given).

The view from Brussels will, however, be different. There is no doubt that UK withdrawal is damaging to the fabric of the EU itself, and an extended period of uncertainty is likely to exacerbate matters. In addition, the outcome of the UK referendum has given succour to Eurosceptic parties in other EU Member States, and the institutions would therefore wish to close off this unhappy episode as quickly as possible. The Commission and foreign ministers have called for a swift start to the exit process, although the German Chancellor has suggested a more cautious approach.

Yet these matters are not quite as binary as they may at first appear, and there will be many difficult conflicts to resolve. For example, ***"Out"*** campaigners consistently noted that the UK is a major market for German exporters, and that Germany would therefore insist on a reasonable trade deal for the UK. This view is driven by an Anglo-Saxon outlook, where economic and market factors will outweigh political considerations. But developments in the EU have so often demonstrated that politics can trump economics – one of the prime examples being the introduction of the euro across a disparate economic area that was entirely unsuited to such an experiment. In addition, Germany was one of the founding and leading members of the EU and it will therefore wish to preserve the unity of the remaining members of the Union in the face of a UK departure. It must therefore be unlikely that Germany will expend much political capital with its remaining partners in order to help to secure a good deal for the UK.

Furthermore, the Commission's desire for a quick deal must in some respects be balanced by the need to ensure that withdrawal is a difficult process that will be significantly to the disadvantage of the withdrawing State – to use Voltaire's phrase, *pour encourager les autres*. The President of the European Commission has also noted that we are now in the early stages of a divorce that is unlikely to be amicable.

It is thus perhaps safe to assume that – whenever the UK Government elects to fire the starting pistol by delivering the Article 50 notification – the ensuing negotiations will be extremely difficult and are likely to absorb the greater part of the permissible two-year period. The primary legal issue at stake in this context is that the commencement of the formal negotiation period can only be triggered by a notice given by the UK Government under Article 50. The announcement of the referendum result does not itself amount to such a notification, and there is no power for the Commission to compel the UK Government to give such notice before the latter wishes to do so. It may be argued that (i) as a matter of international law, the UK is obliged to perform its treaty obligations in good faith and (ii) now that the referendum has resulted in an ***"Out"*** vote, it is incumbent on the Government to give the required notice promptly and to commence exit negotiations. But points of this kind are unattractive and the argument over the timing of the Article 50 notice is likely to remain at the political (rather than legal) level. Leaving aside the EU Treaties themselves, there is nothing in UK law that requires the Government to serve the Article 50 notice at any particular time. The European Union Referendum Act 2015 provides only for the holding of the referendum itself and does not address any of the follow-up issues.

The present status of the UK is that it remains a full member of the EU and will continue to be so until that membership terminates under the Treaty provisions described below. It may be added that the settlement agreement negotiated by David Cameron in Brussels on 18-19 February (including the "emergency brake" on immigration) will not now come into force.

The second aspect of withdrawal relates to domestic legislation required in the UK for that purpose. The withdrawal agreement itself will have to be ratified by the UK Government in order to become effective. This process does not necessarily require a formal Act of Parliament although, under the Constitutional Reform and Governance Act 2010, Parliament has a right to veto the agreement within 21 days. However, implementation of the agreement within the UK will require primary legislation – in particular, it will be necessary to repeal the European Communities Act 1972 so that EU regulations and directives will cease to have effect in this country. But, as ever, the devil will be in the detail. For example, the effect of EU legislation creating employment and other rights may have to be preserved, at least on an interim basis.

The above commentary deals with the status of the preliminary skirmishes between the two sides and some domestic issues but, as noted, these are essentially of a procedural character. It is now necessary to consider the substantive matters – what sort of trading relationship can the UK hope to negotiate with the rest of the EU?

The Single Market

The expression "***Single Market***" refers to the area of the EU which is subject to common rules on the

free movement of goods, services, capital and people.

The UK Government will now wish to negotiate the best possible access to the EU's Single Market for UK goods and services. This will obviously be something of a challenge since the EU will not wish to extend the full benefits of membership to a recalcitrant ex-Member State, nor will it wish to allow such a country to pick and choose. This situation was foreshadowed by the German Finance Minister, Wolfgang Schäuble, in remarks to *Der Spiegel* magazine shortly before the referendum. He noted that a post-Brexit UK would not be granted any special form of access to the Single Market. This was interpreted by some commentators as a German threat to the UK and an unwarranted intrusion into a UK domestic vote. At least from a lawyer's perspective, however, Schäuble was simply stating an incontrovertible fact – the Single Market is created by the EU Treaties, so withdrawal from the EU Treaties implies withdrawal from the Single Market. In the context of the ensuing negotiations, the EU cannot be compelled to extend to the UK an à la carte menu of options to suit the UK's tastes. The cynical observer on the continental side of the Channel may perhaps take the uncharitable view that the UK is trying to preserve the benefits of EU membership without actually paying the full price for them.

The ensuing sections of this briefing examine the various means by which the UK may seek to retain Single Market access, and the options that may be open to it if that objective cannot be achieved. Some of these issues were discussed in our earlier briefings but they merit further examination now that the outcome of the referendum is known.

Bespoke agreement

The withdrawal agreement between the UK and the remainder of the EU does not have to follow any particular form. Indeed, there are no precedents since Article 50 has never previously been invoked. Nevertheless, the best outcome for the UK would be a bespoke agreement that preserves UK access to the Single Market. There would obviously be a price to be paid for that access, but the UK would not be required to participate in the Common Agricultural Policy or other EU programmes. But an agreement of this kind will be very difficult to achieve because, as noted above, free movement of persons is seen as an integral part of the Single Market. However, it may be possible to negotiate a compromise around the latter aspect (i.e. in terms of absolute numbers or by restrictions on access to the benefits system).

The Norway Option

One of the options open to the United Kingdom would be membership of the European Free Trade Association and, through that route, membership of the European Economic Area. This has frequently been referred to as the "***Norway Option***". The current members of EFTA are Norway, Switzerland, Iceland and Liechtenstein. Iceland may in due course fall out of this grouping if its application to join the EU itself is successful.

EFTA was established under the terms of the Stockholm Convention of 1960. It was originally a large organisation – the UK itself was a founding member but departed on accession to EEC

membership in 1973—but it now comprises a handful of countries that either do not wish to join the EU or, otherwise, see it as a stepping-stone to such membership.

Membership of EFTA would involve UK accession to the EFTA Agreement. That Agreement is based on the four primary pillars of the EU itself, namely, the freedom of establishment, the freedom to provide goods and services and the free movement of persons. From a business perspective, the most interesting aspect of this arrangement may be access to the EU for trade in non-agricultural goods and the network of EFTA's free trade agreements with 37 other countries around the globe.

As with any other treaty, however, no country has a unilateral right to accede to the EFTA Agreement. Under Article 56 of that document, the UK could become an EFTA member if approved by the EFTA Council and acceptable terms are negotiated. It should be said that EFTA's main trading partner is the EU itself, and it must therefore be open to question whether the EFTA countries will wish to admit the UK, given the circumstances of its EU departure. The admission of the UK to EFTA would also significantly affect the current balance of the membership structure.

In any event, membership of EFTA alone does not provide access to the EU's Single Market. That objective can only be achieved through membership of the European Economic Area via the EEA Agreement, whose signatories comprise all of the EU Member States and all of the countries within EFTA. Once again, the EEA Agreement is based on the EU's four essential freedoms, and EEA members are also required to follow most EU policies in the spheres of State aid, social policy, consumer protection, environmental issues and company law. Part VII of the Agreement and associated protocols contain mechanisms to calculate the financial contribution of the EFTA members to the EEA and the Single Market, but confer no voting rights in relation to EU decisions. Any European State that becomes a member of EFTA may apply to become a member of the EEA – it is for this reason that EFTA membership is a necessary precursor to EEA accession.

The EEA Agreement allows EFTA members access to the EU Single Market. However, this is at the price of adopting EU regulations and accepting free movement of nationals from the EU itself. Given that the UK's ***"Out"*** vote appears to have been significantly influenced by concerns about immigration, this feature is unlikely to be acceptable to a post-Brexit Government. Nevertheless, EEA membership offers some advantages – for example, the EFTA countries do not contribute to the Common Agricultural Policy, nor do they participate in the policies related to justice, home affairs or the common foreign and security policy.

It may be noted in passing that the UK is *currently* a member of the EEA by dint of its membership of the EU itself. Article 127 of the EEA Agreement allows a member country to withdraw on giving 12 months' notice but, thus far, there has been no real discussion of this particular issue. It may be that governments have assumed that the UK will give such a notice because it will cease to be an eligible member under Article 128 of the Agreement. In addition, Article 126 states that the EEA Agreement "…*shall apply in the territories to which the Treaty establishing the European Economic Community is applied…. and to the territories of Iceland, the Principality of Liechtenstein and the Kingdom of Norway*…" Thus, whilst the UK may remain a signatory to the EEA Agreement, the terms of that document will cease to apply in UK territory when the UK finally withdraws from the EU. There will, therefore, be some legal knots to untie in relation to the UK's current EEA membership, but this is likely to be ancillary to the main EU negotiations.

At all events, and as already noted, the EFTA/EEA route to the Single Market is unlikely to be acceptable from the UK perspective because of the need to maintain the free movement of persons.

The Swiss option

Switzerland is a member of EFTA, but has not acceded to the EEA Agreement. Instead, that country has negotiated a series of bilateral agreements with the EU dealing with matters such as trade barriers, free movement of goods, transport, public procurement and free movement of persons. The broad effect is that Switzerland has many of the rights and obligations of EEA members, but this has been achieved on a bilateral (as opposed to multilateral) basis. EU laws can only apply in Switzerland

if they are approved by a commission in Switzerland itself. However, the package of bilateral agreements stands and falls together; if Switzerland withdraws from one agreement, the EU can apply a guillotine clause to terminate all of those agreements.

These arrangements have now been imperilled by the result of a 2014 referendum requiring the Swiss government to introduce immigration controls by 2017. This would contravene the agreement on free movement of persons and could thus lead to cancellation of the entire package.

Once again, given the influence of the immigration issue on the outcome of the Brexit referendum, the Swiss option is unlikely to provide an appealing solution from the UK perspective. The EU, likewise, lacks enthusiasm for the Swiss structure, which operates outside the more institutionalised arrangements in the EU and the EEA.

It therefore seems likely that both sides would dismiss the Swiss option at an early stage.

Customs union/free trade area

A customs union between a post-Brexit UK and the EU would involve three core features, namely (i) free trade between all members, (ii) the standardisation or elimination of tariffs between the members and (iii) a common tariff on imports from outside the union. The EU currently constitutes a customs union in this sense, but it is difficult to see how a revised customs union could be acceptable to the UK. In practice, the UK would have to accept the external tariffs set by the EU, and this would be inconsistent with the desire to regain sovereignty over the UK's trading arrangements. The EU has also concluded a customs union with Turkey, but this is unsatisfactory from Turkey's point of view since the levels of the tariffs are set by the EU alone.

In contrast, a free trade area involves only the first two features. Trade is thus liberalised between members of the union but each remains free to set tariffs vis-à-vis third countries. Such a structure may well be acceptable to the UK Government but it is difficult to see why the EU would agree to a freestanding arrangement of this kind. It would effectively concede to the UK many of the benefits of the Single Market without membership of the EU or the EEA.

One advantage of a customs union/free trade area is that such an arrangement is generally consistent with obligations under the agreements of the World Trade Organisation because of specific exemptions applicable to those structures.

World Trade Organisation

It will have been apparent from the above discussion that there is no easy and obvious solution to the EU-UK trading arrangements in the post-Brexit environment. The economic and trading ambitions of the UK will run up against the countervailing political agenda of the remaining EU Member States. It is thus necessary to examine possible fallback solutions in the event that no satisfactory withdrawal agreement can be concluded. In that event, the UK will depart from the EU two years after service of the Article 50 notice (unless an extension is agreed).

Reliance on the WTO arrangements has an attraction, in the sense that the structure is already in place and most countries are signatories to the General Agreement on Tariffs and Trade (**GATT**) and the General Agreement on Trade in Services (**GATS**). However, as a third country, UK exporters to EU countries would be subject to the external tariff, and hence would become less competitive. In addition, GATS is less advanced and would not provide a comprehensive template for the provision of services by UK firms. This would clearly be an important issue given the size and importance of the UK services industry.

The immediate aftermath

In the immediate aftermath of the ***"Out"*** vote, many businesses will need to consider their positions both in relation to their continuing business and their customer base. In some cases they will also need to consider their regulatory positions.

For present purposes, it is proposed to consider the position of the financial services industry and issues that may arise in certain transactional contexts.

Financial Services

One of the best-known aspects of EU financial services law is the "***passporting***" system.

This system allows an institution that is regulated in one Member State to passport its regulatory permission into other Member States. The institution is then supervised principally by its "***home***" Member State and does not have to seek separate authorisation in the other, "***host***" locations. The passporting system applies in various sectors of the financial industry including banking, investment services and general insurance. The system allows institutions to establish branches in other Member States, or to provide services there, without further permission.

If the UK cannot negotiate access to the EU's Single Market, then UK institutions would lose the benefit of the passporting system. No doubt the same would apply in reverse, in that EU institutions could no longer passport into the UK. This would mean effectively mean that UK institutions would need to seek authorisation in the "***host***" Member States in which they do business, and EU institutions would likewise have to seek UK authorisation for their operations in this country.

However, smaller institutions that are based solely in the UK may need to consider their position in dealing with customers within the EU. It may be that such institutions are currently passported for ***services*** into other EU countries, and that passport would be lost on final EU withdrawal. Nevertheless, it may be possible to continue doing business with EU customers. A passport or authorisation is only required to provide services ***within the territory of an EU Member State***. However, a UK institution will often be providing its services ***within the UK***, even though the customer is resident in the EU or elsewhere. Thus, for example, a UK institution may be able to continue offering services:

- to EU customers that have approached the institution to access its services (whether by introduction or advertising);
- to EU customers that require periodic visits from staff; and
- to customers using an internet service.

UK institutions will therefore retain a degree of flexibility to deal with EU customers even in the post-Brexit era.

Real estate and other transactions

One of the challenges to the financing and completion of new transactions is posed by the changed environment in the UK and the extent to which this affects the valuation of assets.

Most notably, the Royal Institution of Chartered Surveyors has advised its members to include a new reservation in valuations to the effect that Brexit has introduced a dimension of uncertainty in the valuation process. This may tend to make buyers more cautious, and financiers may insist on lower loan to value covenants. The combination of these factors will inevitably lead to a pause in the market until the situation becomes clearer.

On the other hand, overseas buyers who do not require bank finance may be looking carefully at opportunities bearing in mind that, as a result of turbulence in the currency markets, the cost of purchasing the necessary sterling amounts may have fallen significantly in terms of their home currency.

Whilst the above discussion is focused on real estate, similar considerations may apply equally to other asset acquisitions.

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Conclusions

The UK is at present in something of a twilight zone – still a member of the EU but clearly on its way out.

As demonstrated above, there are various negotiating positions available to the UK. The ideal outcome would include continued access to the Single Market (including the continued use of the passporting system in the financial services sphere). However, this will be unpalatable to the EU side unless the UK agrees to a suitable financial contribution and a compromise is reached on free movement of persons.

This briefing has been prepared by Charles Proctor, a member of our banking and finance team. It does not necessarily reflect the views of the firm as a whole.

Further information?

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