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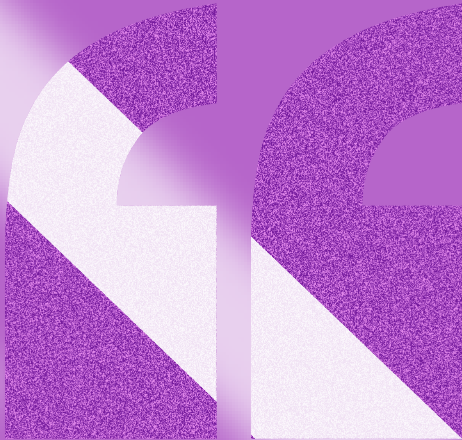

A BREXIT TRANSITION PERIOD

WASTING ASSET OR BUSINESS NECESSITY?

– THOUGHT LEADERSHIP

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A BREXIT TRANSITION PERIOD – WASTING ASSET OR BUSINESS NECESSITY?

The UK is due to leave the EU in March 2019 and it is now just over a month since Theresa May, the UK Prime Minister, sought to give new momentum to the Brexit negotiations and talked in Florence about the need for an implementation period so that businesses and public services only have to plan for one set of changes. Mark Poulton, Head of Corporate, London, discusses with Clifford Chance experts the timeline for achieving the proposed implementation or transition period, the legal challenges involved, the implications for trade and for multinational businesses outside the financial services sector more generally.

The Need for a Transition

The need for an implementation period is not a new concept, it had been foreshadowed by the UK Prime Minister in March and was also addressed in the Council of the EU negotiating directives in May. The directives made clear that there would be two phases to the Brexit negotiations: the first phase principally to address safeguarding the rights and status of EU27 citizens living in the UK and UK citizens living in the EU; Northern Ireland; and the financial settlement; and the second phase relating to the agreement regulating the future relationship between the EU27 and the UK and any transitional arrangements. A new set of negotiating directives is required for the second phase of negotiations, and negotiations on the second phase, the EU27 say, can only proceed once 'sufficient progress' has been made on the first.

Mark Poulton says, "The financial sector has been preparing for Brexit by assessing their existing structures, businesses lines, license and authorisations and many financial institutions are planning to start implementing in the coming months the changes they would need to make if the status quo does not continue post-Brexit. For the most part multinational businesses and businesses with multinational supply chains are considering the implications of Brexit too, although many don't need to make significant changes to how they conduct their businesses just yet."

However, the UK Chancellor of the Exchequer, Philip Hammond, acknowledged that the 'cloud of uncertainty' is already affecting business and dampening investment and he recently called on the EU27 for a more rapid response on a transition arrangement, which he described as a 'wasting asset'.

Process, Timeline and When Businesses Will Have Greater Certainty

Following the five scheduled rounds of Brexit negotiations so far, and the 19-20 October European Council meeting, Phillip Souta, Head of UK Public Policy at Clifford Chance says, "We are almost seven months into a 24 month process and that 24 month process we should think of as 18 plus 6 – with 18 months for negotiations and 6 for ratification."

He adds that, "The UK government hoped to have reached a deal on transition by now. There has been an impasse which the UK Prime Minister sought to break with her Florence speech, where she made her offer amounting to €20 billion for the current EU budget period and separate to that, payment of existing obligations. The EU decides whether and when 'sufficient progress' has been made and that did not happen in October, which was a setback. The EU knew that would be damaging for the already weakened UK Prime Minister, so they gave her an assurance that they would start scoping a transitional and future agreement on their side in anticipation for a breakthrough, which is now hoped to take place at the critical December Council."

Michel Petite, Counsel at our Paris office and formerly Director General of the EU Commission's Legal Service, says that from the EU perspective, "The outcome of the European Council was very predictable."

He notes that, "There is no sign of divergence between the 27 on the sequence established at the beginning with the Commission: transition and a future agreement will only be discussed when an agreement in particular on finances, is in sight. The reference in the conclusions to the Commission starting to scope the future agreement and a possible agreement internally is a political signal without much content, as the Commission has already been scoping them for some months." If the 'sufficient progress' bar is reached in December, the Commission will also prepare an extension of its mandate.

There is the question of whether the transition period is really, as the UK Chancellor of the Exchequer said, a 'wasting asset' and how important it is for businesses to gain further certainty in the coming months. Phillip Souta says that, "The longer it takes to agree, the less likely it is to achieve the UK government's objective of encouraging investment in the UK and stopping businesses from executing contingency plans that involve moving operations out of the UK". In any event, the UK will struggle to get a legally binding assurance of a transitional period until everything is agreed in late 2018 or early 2019. Both the EU and the UK's mantra has been 'Nothing is agreed until everything is agreed'. "However, an agreement in principle at this stage would be a reassuring step in the right direction", adds Phillip Souta.

For businesses, transition is still clearly a key priority. Five of the UK's largest business organisations, led by the Confederation of British Industry, demanded 'urgent agreement' of transitional arrangements, adding that "agreement (on a transition) is needed as soon as possible, as companies are preparing to make serious decisions at the start of 2018, which will have consequences for jobs and investment in the UK." The UK Prime Minister has indicated that it would only be possible to agree transitional arrangements if and once a future agreement is concluded. Phillip Souta comments that, "The future agreement is highly unlikely to be concluded before November 2018, but overall, whilst there is uncertainty about whether and when a transitional arrangement will be agreed, it is still Clifford Chance's base case that it will be."

What a transition period will involve

What would a possible transition or implementation period involve? The UK government is clear that the UK will leave the EU on 29 March 2019, but it has asked for an implementation period of 'around two years' based on existing EU frameworks and has said it wants to maintain the 'status quo' for business for this period.

Michel Petite says that, "The EU's view was always that a transition period would have to be simple, and effectively a continuation of the status quo. So the scenario is now finally clear also to the UK: stay in the single market and the Customs Union over a period, as a non-member of the EU. For the UK, it will imply accepting any new EU standards during that period, and their uniform interpretation by the Court of Justice of the European Union. Not taking part in the proper decision-making, but consulted on proposed new legislation."

From a UK perspective this should be reasonably straightforward. The key point is that the UK has said that it will abide by changes in EU law during the transition and jurisdiction of the CJEU. "Many do not believe two years is enough – manufacturing associations for example have asked for a five year transition for product standards, and the EU has indicated that it does not want sector-by-sector transitions. The UK government is reluctant to talk about longer than two years in any case, as that is politically very difficult for the Conservative Party," adds Phillip.

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—**MICHEL PETITE**
Avocat of Counsel
Paris

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– **PHILLIP SOUTA**
Head of UK Public Policy
London

Legal Perspectives on Transition

A key question is how a transition or implementation period would be achieved as a legal matter, and how it would interact with the UK's proposed EU (Withdrawal) Bill. Also, what would that mean for trade?

A transitional framework is likely to look much as it does today. It would effectively maintain the current levels of market access in terms of goods, services, people and capital between the EU and the UK, underpinned by the same regulatory and supervisory framework. During this period there would not be any regulatory divergence between the UK and the EU. The possibility of divergence once that period is up depends on the terms of the future agreement.

Considering whether a transitional arrangement could be made under the Article 50 of the Treaty on European Union process, Michel says that, "If short and temporary then the transition could be in the Withdrawal Agreement. This is however legally uncharted territory." If it were in a separate agreement, ratification would be more complex. In Michel's view, a CJEU challenge of a 'holding period' under article 50 is very possible. Such a challenge could be fast-tracked in 6 to 12 months. If uncontested in the Withdrawal Agreement it would only require a Qualified Majority, but if the CJEU upheld a challenge it would require all member state approval. "However, a short and temporary arrangement, of say two years, would probably be able to hold the road," adds Michel.

Withdrawal Bill

Any Withdrawal Agreement will need to be given effect under UK law by the EU Withdrawal Act. Numerous amendments have been proposed to the Withdrawal Bill and the progress of the bill in the House of Commons has been subject to delay as the government seeks to ensure its passage. The Withdrawal Bill needs to be settled and enacted before March 2019.

On how the Withdrawal Bill ties in with the Withdrawal Agreement, Phillip says, "The detail is not yet clear but the framework is. The EU Withdrawal Bill repeals the European Communities Act 1972 and thereby stops the UK's membership of the EU having domestic legal effect. It stops future EU law having direct effect in the UK, but transforms current EU law into UK law. The Bill as drafted gives the government wide-ranging 'delegated' powers – often referred to as Henry VIII powers – to implement any Withdrawal Agreement and rectify UK law to make sure that it functions in line with whatever is contained in the Withdrawal Agreement." He adds that, "The Bill will be one of the many areas where opposition parties and Tory backbenchers can exert pressure on the government, and seek to influence the outcome of the Withdrawal Agreement negotiations."[1]

Michel explains how UK law will be expected to be kept in line with EU law, saying that, "We have been here before. Where a country is part of the internal market and the Customs Union, but is not a Member State, the solution has always been that new EU legislation is endorsed by a Joint Committee of a political nature. The measures would become binding in the UK by way of decision of this Committee. A jurisdiction capable of uniformly interpreting the new rules would also be required. The EU will certainly insist that the CJEU has this function."

Trade, Borders And Customs

Turning to the specific area of trade and border controls during the transition period, Alice Darling, a Clifford Chance lawyer and trade expert, comments on the most recent customs white paper, released on 9 October, in which the UK government indicated that its transitional period would involve a time-limited customs union, with a shared external tariff. "To a large extent, trade between the UK and the EU would continue as before during the transitional period. No tariffs would be charged, there would be no additional customs processes, and as regulations and administrative procedures are unlikely to change,

[1] For further information about the progress of the UK's EU (Withdrawal) Bill, see our briefing here - https://www.cliffordchance.com/briefings/2017/07/brexit_european_unionwithdrawalbillandth.html

there will be no additional Non-Tariff Barriers," says Alice.

Bearing in mind that companies today have globalised and complex supply chains that often involve goods coming from outside the EU and the UK, Alice notes that, "Free Trade Agreements between the EU and a third country will stop applying to the UK at the moment it officially leaves the EU. This is one of the areas in which a transitional arrangement between the UK and the EU will not maintain the status quo." If the UK wants to keep the benefit of these FTAs during the transitional period, it will need to negotiate with the individual countries and each will have to specifically agree that the trade agreement will continue to apply during the transitional period.

There is an added level of complexity. As a result of the proposed UK-EU Customs Union and the shared external tariff the UK will have to apply the EU's tariffs to third countries, those third countries will not be required to apply preferential tariffs to the UK. There is therefore less incentive for a third country to agree to apply their FTA with the EU to the UK.

If the UK does manage to agree that its FTAs should continue to apply, certain terms, such as Rules of Origin, will have to be negotiated and the treaties amended to ensure that companies will still be able to take advantage of the preferential tariffs. Those rules are quite complicated but essentially they are the rules that determine the economic nationality of a product – whether it is an 'EU' product or a 'UK' product, for example. They ensure that the correct tariff is levied on a good. A good must comply with rules of origin to take advantage of preferential tariffs under an FTA. The rules vary according to the specific good but, for example, a car must be 'sufficiently processed' in the EU in order to benefit from South Korea's preferential tariffs, meaning that no more than 45% of the value of all the materials used in manufacturing the car can have been imported from outside the EU or South Korea. Once the UK leaves the EU, any manufacturing that takes place in the UK will no longer count towards the 'sufficiently processed' test. This means some products will fall through the gaps – they will not be considered UK goods or EU goods and therefore won't be able to take advantage of the preferential tariffs.

Alice notes that there is a way around this, saying that, "There are arrangements which allow for cumulation of rules of origin meaning that UK and EU content would be added together for the purpose of complying with rules of origin. But this would require both the EU and the third country to agree, and for the EU to amend its FTAs with third countries."

On the question of whether the UK would be permitted to negotiate new deals during the transition period, Phillip says, "Being a part of the EU's Customs Union and Common Commercial Policy – which is to say trade policy – prevents a Member State from negotiating different deals with third countries as that is broadly an EU competency. The UK has however been conducting 'preliminary discussions' with countries such as the USA with a view to ensuring it is in a position to hit the ground running on departure." He adds that, "The EU has been generally content with that."

Alice comments that, "It is also important to note that the indications are that major trading nations such as Japan, for example, are more likely to want to focus initially on their own agreement with the EU, and wait until the UK-EU path ahead is clearer before negotiating with the UK."

Two Further Examples – Tax And Aviation

It was reported some time ago that on withdrawal the UK will lose access to 759 treaties with third countries covering not just trade but also regulatory cooperation, fisheries, transport, customs, nuclear and agriculture.

There are also tax treaties between EU members and third countries. Many of the US's tax treaties with EU members contain a 'limitation on benefits' article, which excludes treaty relief unless the EU entity satisfies certain conditions. Those

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—**ALICE DARLING**
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Now is the time to be assessing the Brexit impact across the wider business, asking the right questions and so identifying red flag areas to keep an eye on, and take action on, as we move towards March 2019.

—**ISABELLE HESSELL TILTMAN**
Head of Corporate Thought Leadership & Strategy Delivery
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conditions in many cases relate to whether the majority of the EU entity's shareholders are EU persons.

Mark gives the example of a Luxembourg private company, holding US shares and owned by a UK investor. Right now, this Luxembourg private company will benefit from a reduced rate of US dividend withholding tax. However, after Brexit, it will cease to benefit from the treaty, because it will no longer be ultimately owned by EU shareholders. He notes that, "Transition won't help, and there is no fix short of Luxembourg renegotiating their tax treaty with the USA."

Another example is aviation treaties. Phillip notes that, "Following Brexit, if there is no agreement in that area, there would be no automatic access to routes between the UK and EU for their airlines. The EU and the UK can agree transitional arrangements. However, UK airlines would not benefit from EU agreements with third countries, for example the EU-US open skies agreement. The UK has various options it can pursue to solve this and it is difficult to imagine there not being an agreement in this area because it is in all parties' interests to reach one, but the point is there is a hard deadline and the transitional arrangements don't address this."

Services

Trade in services is critical to the UK economy, accounting for about 80 per cent of GDP. A transition arrangement is expected to maintain the current right to establish a company in another EU country and the freedom to provide services across borders. However, there are of course still significant barriers to service provision across the EU, such as professional qualification rules. Considerable market integration at the EU level has been achieved in the area of financial services. The key question here, as elsewhere, is how far will the future agreement go.

What Should Businesses be Doing?

What should multinational businesses in the 'real' economy be doing now? Isabelle Hessell Tiltman, Head of Corporate Thought Leadership at Clifford Chance says that, "We are seeing UK businesses, and multinational businesses with UK operations, looking at their operations and assessing the impact Brexit could have – top of the list is supply chains, distribution channels and impact on workforces, but businesses also need to be looking more widely than that – at their commercial contracts, current IP registrations, data sharing practices, financing sources, and so on."

She notes that, "Now is the time to be assessing the Brexit impact across the wider business, asking the right questions and so identifying red flag areas to keep an eye on, and take action on, as we move towards March 2019." Gathering all this information, particularly the analysis of supply chains and rules of origin, can be a time-consuming process so it is advisable to be onto it now and to be efficient. The assessment businesses need to make is broadly against two scenarios: the 'soft' scenario of a transition period and then a best guess at what a comprehensive UK/EU arrangement will look like, coupled with new third country trading relationships; and the second scenario being the most challenging case from a risk perspective – a disorderly hard Brexit in 2019, reverting to WTO rules.

Red Flag Areas

One red-flag area is material contracts. Businesses should be looking to identify any contracts which might become 'commercially unviable' if the UK ends up falling back on WTO rules, with tariffs on imports – these contracts should be identified now so that they can be checked for provisions that potentially deal with the situation, and whether there are options to terminate.

Another example that might throw up a red flag could be a European business with contractual territorial provisions that cover its UK operations. For example, instances where businesses have been granted exclusive rights covering the 'territory of the EU', and perhaps it is not clear from the drafting whether those rights survive a Member State ceasing to be a member. Isabelle says that, "If that exclusivity is being relied on currently to

protect the business's position or operations within the UK, then this becomes a contract to watch." And depending how that provision is drafted it could cause problems in 2019 even if there is a 'transition', because the UK would fall outside the definition of EU member at that point.

Intellectual Property is a crucial area for many businesses. Everyone is hopeful there will be a mechanism that will allow for a form of conversion or transformation of existing EU unitary trademarks and designs into UK national rights, without loss of priority. But still there is some uncertainty, about how long use in the EU27 would continue to protect transformed trademarks in the UK from non-use revocation, for example. Also, other IP rights which are important in certain sectors, including geographic indications and protected designation of origins, do not currently have national equivalents in the UK, so there is not currently the option of transformation into a national equivalent right. Life sciences and pharmaceutical businesses are also concerned that the system for supplementary protection certificates currently depends on European regulations. An IP portfolio review may be helpful to assess which rights are at risk and what steps should be taken.

Conclusions

Michel Petite notes that, "A transition period now seems to be required, due to the sloppiness of the negotiations on withdrawal. A holding period would give some comfort; however I do not see how it would reassure business for the longer term, as it would say nothing of the future EU/UK relationship."

In terms of the overall direction of travel, Phillip Souta says that, "We will soon have a much better idea of where we are going. If the negotiations are given the green-light to move to phase 2 in December (and this is still quite a big if), agreement in principle on the Withdrawal Agreement including a transitional period is the likely outcome, but there is still a material risk of a hard Brexit if this is not joined up with the future agreement."

Mark Poulton observes that, "There may be some greater certainty by the end of the year which may help businesses. We will only know for sure later next year if and when final agreement is reached, but one thing that is for sure now, businesses do need to plan for more than one set of changes – some changes would be postponed by a transition arrangement but some changes on withdrawal are inevitable."

On supply chains, Alice Darling notes that, "Companies need to assess their supply chains now so they are aware of the impact on their business of the UK no longer having trade agreements with third countries – this is one area that will not necessarily stay the same during a transitional period."

Isabelle Hessell Tiltman concludes that, "Businesses can't take a transition arrangement for granted and, if there is one, they can't take it for granted that a transition period will delay all the implications. So businesses need to be thinking through the repercussions now, and also anticipating them when doing M&A and negotiating other important agreements."

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