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BREXIT UPDATE: GERMANY AND FRANCE NO DEAL MEASURES

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While the UK Prime Minister and the European Union still debate a possible way out of the Brexit deadlock, continuing uncertainty results over the UK departure from the EU. As a consequence, a no deal Brexit, i.e. the scenario where the UK leaves the EU on 29 March (or later) without a withdrawal agreement and a transition period in place is an increasingly possible eventuality, for which different European countries have been preparing contingency plans.

Therefore, we continue our analysis of the no-deal preparation in different EU jurisdictions. For an outline of no deal preparation in Italy, Luxembourg and Ireland, please click here to view our previous newsletter.

As per the jurisdictions examined previously, the aim of this wave of national legislation in EU states is to limit the risks connected with such a situation, ensure financial stability, the integrity and the operational continuity of markets, and protect intermediaries and markets participants alike, through the introduction of an appropriate transitional period during which such entities can continue to operate, similarly to the transitional period planned in the event of an agreement between the UK and the EU.

GERMANY

No deal Brexit and corporate entities

The first no deal legislation, the Fourth Act to Amend the Transformation Act (the "**Transformation Act**") enacted in Germany centred mainly around corporate law, and was passed by the German parliament on 14 December 2018 and allows UK limited companies to remain in operation in Germany by becoming legal German entities.

In the event of a no deal Brexit, currently British companies with administrative headquarters in Germany will lose their freedom of establishment under EU law. Limited liability companies will then be treated as partnerships and shareholders will lose the privilege of limited liability. This applies in particular to UK private companies limited by shares with administrative headquarters in Germany, of which an estimated 8,000 to 10,000 companies exist. They are a remnant of the limited boom prior to the introduction of the "*Unternehmergesellschaft*" ("UG" – the limited liability company).

The Transformation Act now offers these British companies a chance for cross-border mergers into commercial partnerships (i.e. into a GmbH & Co. KG). Until now, the corresponding rules (found in the EU mandated law *§§ 122a et seq. of the Transformation Act)* have been limited to corporations. But with the new law, German lawmakers have exempted small companies from the strict capital-raising requirements applied to corporations. In certain cases, eliminating merger reports and merger audits will also make the procedure much easier.

Finally, Germany will grant a transitional period for merger proceedings involving a British company if the draft terms of the merger have been notarised before the UK leaves the EU or before the expiry of the transitional period resulting from a withdrawal agreement is in place.

Even though this legislation makes it easier for UK limited companies to remain in operation in Germany, the German legislator has no influence over obstacles on the British side, such as potentially high professional fees, court costs or any cumbersome procedures. The new German law is also welcome because, although the European Court of Justice ruled last year that a company registered in one EU Member State should be permitted to "migrate" to another EU Member State, British law does not currently permit a British company to migrate out to another EU Member State.

No deal Brexit and financial services

On 4 January 2019, the German Government initiated a draft act concerning specifically Brexit (*Brexit-Steuerbegleitgesetz)* (the *"***Draft Brexit Act***"*) which would be directly applicable in Germany in the event of a no deal Brexit.

The Draft Brexit Act covers the following two areas:

- Brexit-related amendments to German tax law: current fiscal privileges relying on the UK's EU and EEA membership will, post-Brexit, continue to apply to those fiscally relevant actions which were executed pre-Brexit. This entails amendments to the Income Tax Act, the Corporation Tax Act, the Transformation Tax Act and the Foreign Tax Act; and

- amendments to several financial services acts, introducing a possible transition period during which UK financial service providers could continue to provide banking and financial services in Germany, and wind up existing insurance contracts in Germany until the end of the transition period.

The amendments regarding financial services replace a potential harmonised response on an EU level, in case the withdrawal agreement is not passed by the UK parliament.

The Draft Brexit Act would amend the German Banking Act (*"***KWG***"*) and the Insurance Supervision Act, empowering the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzaufsicht, "***BaFin**") to grant companies domiciled in the UK, which have hitherto operated cross-border in Germany or have a German subsidiary, to continue their existing business. According to the Draft Brexit Act, it is at the discretion of BaFin to order the application of the EU passport regime in whole or in part to UK-licensed entities for a transitional period not exceeding 21 months starting on a no deal Brexit day. BaFin can do so, for example, by means of a general decree with effect for all UK entities concerned.

The application of the EU passport regime to banking transactions or financial services can only be considered insofar as the activity is closely related to pre-Brexit contracts. The explanations annexed to the act make it clear that such a close connection is to be presumed if the activity is legally or economically linked to existing contracts. The Draft Brexit Act would thus give affected UK-based companies the opportunity to continue their business in Germany pursuant to section 32(1) KWG within the transitional period.

For insurance services, the Draft Brexit Act is narrower and only permits those insurance contracts which were agreed pre-Brexit to be continued and wound up during the transition period. According to the explanations, this means that UK insurers have to terminate existing contracts with German counterparts and wind them up or to establish a subsidiary in Germany and have it licensed within the transition period.

With regard to the German Covered Bond Act, the Draft Brexit Act proposes protection for British assets covered pre-Brexit. These may continue to be used as coverage until their maturity. In the Building Societies Act, the additions grant protection for existing investments in the UK and for the security of claims under real estate liens. The amendments made to the Investment Ordinance and the Pension Fund Supervisory Mandate mean that German insurance companies and pension funds may keep assets located in the UK as part of their security assets to fulfil their obligations towards insured pensioners, in so far as these assets have been acquired prior to 28 March 2019.

Conclusion

In conclusion, the approach in Germany is to address directly the consequences of a no deal Brexit for financial services by upholding parts of the existing passporting regime for the benefit of UK financial service providers operating in Germany for a transitional period of up to 21 months post-Brexit. However, this would be limited to services agreed upon before Brexit and areas contained in the Draft Brexit Act. The time allotted would give UK entities opportunity to adhere to the German requirements applicable to third country entities. Consequently, the Draft Brexit Act facilitates grandfathering but offers less market access than the pre-Brexit EU passporting regime.

FRANCE

The French Brexit Act

In October 2018 the French Parliament was presented with the *loi* n° 2019-30 (the "**French Brexit Act"**), which has now been activated. It addresses the following areas:

- British nationals living and/or working in France as well as the circulation of goods between France and the UK. It also aims to preserve the attractiveness of France for UK businesses already present in the country and to facilitate their continuous operation; and
- in the areas of banking, financial and insurance activities, it authorises the Government to set out ordinances (within the next 12 months) that will:

a) safeguard the enforcement of settlements concluded via interbank and delivery systems of third countries, including the UK;

b) appoint authorities to supervise activities involving securitisation;

c) introduce specific rules for the management of collective investments whose assets comply with investment ratios in European entities; and

d) ensure the continued operation of major agreements in the financial sector and secure the completion of ongoing contracts before loss of recognition of existing British agreements in France.

As it has been established in the UK, and also in France, the *Haut Comité Juridique de la Place de Paris* (a legal independent committee) points out that Brexit does not pose a risk for the continuity of contracts, the performance of which was started prior to Brexit, since in these contracts the parties were irrevocably committed before exit day. For example, this would be the case for loan agreements where the money has already been advanced by a British bank to a French borrower, or an insurance contract which has already been entered into and the risk calculated before Brexit.

On the other hand, there is a risk for the continued operation of loan agreements with a number of conditions precedents, including the ones which are not met before Brexit, or uncommitted facilities where the absence of lender's commitment pre-Brexit would not allow a British lender to lend without violating the French banking monopoly rules post-Brexit. The increase in the credit amount of the facility after Brexit could jeopardise the continuity of all or part of the stated contract when at least one of the lenders does not have a banking licence authorising it to carry out banking transactions on French territory. According to French case law, failure to comply with the required banking licence is not likely to result in the invalidity of loan contracts. However, under French law non-compliance with banking monopoly rules is a criminal offence. A system that enables the institutions which no longer enjoy passporting rights to fulfil their existing obligations is welcomed as it will ensure a smooth transition to the post-Brexit status quo.

The same logic applies to insurance contracts. Automatic renewal of contracts with a British insurer and/or change to the covered risk will not be possible, unless the British insurer transfers the contract to an establishment or branch duly licensed in the EU. It will be up to the British insurer (under the supervision of authorities in the UK and the EU) to inform its clients and the insured parties to take the necessary steps to obtain post-Brexit coverage from a licensed insurer in the EU. It is worth noting that in contrast with the banking precedent mentioned above, the French Insurance Code stipulates that an insurance policy concluded with providers which do not have a valid EU licence is deemed invalid. Such outcome will not follow, if the insured parties and beneficiaries acted on good faith. However, failure to comply with the restrictions is punishable under French criminal law.

With the objective of ensuring the continuity of ongoing contracts, the French Parliament has deliberately provided the Government with broad powers in order to guarantee legal certainty in as many scenarios as possible. Nevertheless, the French Parliament has reserved its "right of information" on the measures which will be taken by the Government.

British establishments will still be able to participate in the syndication of loans granted to French business borrowers by lending institutions, finance companies, or AIF and UCITs duly authorised to conduct their business in and from France post-Brexit. They may also act indirectly as first original lenders to French business borrowers without an EU license by establishing a securitisation entity in France or a specialised financing entity (which may benefit from the European ELTIF label). Government order n°2017-1432 of 4 October 2017 modernising the legal framework for asset management and debt financing (now codified in article L.511-6, 4° of the Monetary and Financial Code) created two new loopholes in the restrictions on providing banking services in France. The aim was to encourage the inclusion of "*institutions governed by foreign law (…) whose object or business is similar to that of [licensed] entities*" in the circulation of unmatured loans and to enable securitisation vehicles to grant loans in France and in the EU without a banking license, which could prove to be useful in the current context.

Financial Services Legislation

After activating the French Brexit Act authorising the French Government to set out ordinances relating to transitional measures due to a no-deal Brexit, on 6 February 2019 the French Government published an *ordonnance* about financial services (the "**Order**").

The Order seems to focus on derivatives and insurance contracts only; banking transactions or investment services are not covered, nor does it include the issue of local offices. The scope of the Order covers the following areas, amongst others:

- **ISDA Master Agreements:** ISDA master agreements are allowed to derogate from *anatocisme* (i.e. the French rule of compounding of interest which prohibits the compounding of interest due for less than one year – which is qualified as public policy under French law). This rule was one of the obstacles often used to justify the use of English ISDA contracts. The scope of eligible operations for close-out netting is extended to spot exchange transactions, the sale, purchase, and delivery of precious metals or operations on CO_2 quotas;
- **Monitoring of UK entities' compliance under ongoing contracts**: The *Autorité de contrôle prudentiel et de résolution* (**"ACPR"**) will continue to monitor UK entities' compliance with their obligations under existing contracts post Brexit. The ACPR's power to sanction acts, such as breaches or offences, committed before exiting the UK is maintained. The Order has also designated the *Autorité des Marchés Financiers* as the supervisory authority for securitisation activities;
- **Safeguarding of the performance of insurance contracts:** The Order aims to be an incentive to transfer insurance activities that can no longer be carried out by UK entities post Brexit. This is to ensure legal certainty for French insured persons with confirmation of the obligation to perform the insurance contracts validly subscribed before Brexit even if the UK insurance company loses its European passport post Brexit and is no longer in a position to enter into new commitments. Additionally, the Order confirms that post Brexit, no renewal will be allowed by a non-EU licensed entity, nor it will give rise to any new transaction involving the issue of new premiums. However, this prohibition would not apply to the payment of premiums that the subscriber is required to pay under a contract concluded before Brexit. The same will apply to the payment of claims by the UK insurer post Brexit; and
- **transfer of UK activities to European subsidiaries**: Incentives have been introduced for circumstances where the activities of UK entities will have to be transferred to their European subsidiaries- if a UK regulated entity has or will have a subsidiary in the EU, the transfer of its activities will be facilitated at EU level. The Order provides for a specific mechanism that may apply to situations in which the recipient of the offer (i.e. the client), that is in France, remains passive towards the offer of a new relationship. This mechanism will consist of a framework agreement that will exist between (i) the EU regulated entity as the offeror, and (ii) the client, to whom the offer is made, the latter will have been deemed to have expressly (within a certain period of time) accepted to enter into new transactions with the EU entity. This new framework agreement concluded between these two entities will have the characteristic of being "virtually" identical in all aspects to the original agreement between the client and the UK parent company. It should be noted that this mechanism will only be maintained in force for a period of twelve months.

It is important to note that the Order does not contemplate any transitional measures for UK regulated entities, so that they will not be allowed to exercise any new regulated activity on the French territory post Brexit. The logic behind this is simple: as the UK will become a third-party and lose its passporting rights, it will no longer be able to operate in France unless it obtains a French (or another EU Member State's) license. The approach taken is to safeguard only the performance of ongoing contracts between French/EU entities.

CONCLUSION

Although so far the French approach seems to be the strictest in comparison to other EU Member States, it still follows on the footpath of other EU countries, that have, in different degrees, allowed only certain activities to continue for a transition period post no deal Brexit, barring new trades and activities from being automatically granted post no deal Brexit.

NEXT STEPS

With only a few weeks to go until the UK leaves the EU, we will continue to send out regular updates on the development of no deal preparations in these and other EU jurisdictions, as soon as they are available.

For more information, and any guidance or advice on the impact of Brexit on your business, Cleveland & Co, your External in-house counsel, are here to help

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