SULLIVAN & CROMWELL LLP

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"Brexit"—Vote by the UK to Leave the EU

Legal Implications

In a referendum held in the UK on June 23, 2016, a majority of those voting voted for the UK to leave the EU. This memorandum briefly summarizes some of the main legal implications of the "leave" vote and is primarily for the benefit of those outside the UK who have not followed the referendum campaign in detail. For further information, please get in touch with your usual Sullivan & Cromwell contact or any of those persons listed at the end of this memorandum.

The "leave" vote has no immediate legal effect under either UK or EU law

The UK currently remains a member of the EU and there will not be any immediate change in either EU or UK law as a consequence of the "leave" vote. EU law does not govern contracts and the UK is not part of the EU's monetary union.

However, the "leave" vote now heralds the beginning of a lengthy process under which (i) the terms of the UK's withdrawal from, and future relationship with, the EU are negotiated and (ii) legislation to implement the UK's withdrawal from the EU is enacted (primarily in the UK, but also at the EU level and in other EU member states to the extent necessary).

The terms of the UK's future relationship with the EU will need to be negotiated

The ultimate legal impact of the "leave" vote will depend on the terms that are negotiated in relation to the UK's future relationship with the EU, as described below. This is currently the principal source of uncertainty as to the legal implications of the "leave" vote. Each of the UK government and the EU will need to formulate their respective positions for the withdrawal negotiations over the coming months. Once this is done, the likely direction for the UK's future relationship with the EU will become clearer, allowing for a sharper focus on the legal implications.

It is not yet clear what terms the UK will seek to negotiate with the EU (or what the EU will offer to the UK) in relation to its withdrawal from, and future relationship with, the EU. To date, there has been no consensus, even among "leave" campaigners, as to the terms which the UK should seek in these negotiations. The key factor is the extent to which the UK wishes to continue to benefit from any part of the EU single market (i.e., the current EU regime which allows for free movement of goods, services, capital and persons, and freedom of establishment, within the EU).

There are several different existing models that could be adopted, either alone or in combination with one another. These include the following:

- ***Total exit***: the UK leaves the EU and does not continue to benefit from any part of the single market. The UK either relies solely on the rules of the World Trade Organization (which include rules governing the imposition of tariffs on goods and services) as the basis for trading with the EU or negotiates a new bilateral trade deal with the EU.
- ***The Norwegian model***: the UK leaves the EU but joins the European Economic Area (EEA). The EEA is constituted by the EEA Agreement among the 28 EU member states and three countries which are not EU member states (Norway, Iceland and Liechtenstein), and extends the free movement of goods, services, capital and persons beyond the EU to those three countries. Under this arrangement, EU law relating to these four freedoms (which could be modified by the EU without the UK's consent) would largely continue to apply to the UK, and the UK would continue to have full access to the single market.
- ***The Swiss model***: the UK leaves the EU and does not join the EEA as described above. It may instead rejoin EFTA (an intergovernmental organization comprised of European countries who are not members of the EU – the UK was a member of EFTA before it joined the EU in 1973). Currently, only Switzerland is a member of EFTA but not a member of the EEA. Switzerland has (on its own behalf rather than as a member of EFTA) negotiated a large number of sector-specific bilateral agreements with the EU and has access to some parts of the single market, but is excluded from the single market in some major sectors (for example, Switzerland is not part of the single market in the financial services sector).

Although the EU treaty provides a framework for a member state to withdraw from the EU, this particular framework has never been used before and it is therefore not certain how it will operate in practice

The EU treaty provides (in article 50) a mechanism whereby a member state can withdraw from the EU and notify the European Council of its intention to do so. The giving of such a notice triggers the start of a two year time period for the negotiation of a withdrawal agreement between that member state and the EU. The withdrawal agreement is required to be approved by (i) the 27 EU member states excluding the withdrawing member state (by qualified majority rather than unanimously) and (ii) the European Parliament (by simple majority).

No announcement has yet been made by the UK government as to when it intends to deliver any notice of withdrawal under article 50.

The withdrawal of the UK from the EU would take effect either on the effective date of the withdrawal agreement or, in the absence of agreement, two years after the article 50 notice referred to above, unless the UK and all the other EU member states agreed to extend this date.

Although the timescale is not at all clear at this stage, it appears likely that the withdrawal of the UK from the EU (both the conclusion of a withdrawal agreement and the arrangements for the UK's future relationship with the EU) will take more than two years to negotiate and conclude. Even the withdrawal of Greenland (an autonomous country within the state of Denmark) from the EU, where the issues were far more limited, took three years from the relevant referendum vote to come into effect.

The UK will need to decide the extent to which existing EU law should continue to apply in the UK

Since 1973, the UK has implemented a vast number of EU directives into UK law. These will remain effective as UK law unless they are amended or repealed. This means that, in a total exit, or if the Swiss model were to be adopted, there will of necessity be a massive exercise, spanning several years, in which the UK government will need to determine which aspects of these EU directives it wishes to either (i) retain, (ii) amend or (iii) repeal.

In addition, the UK would need to enact new laws to the extent it wished to retain:

(a) any EU laws which had been enacted by means of EU regulations, which are currently directly applicable in the UK without any implementing measures; or

(b) any other EU laws which had direct effect in the UK without any implementing measures (e.g., provisions of the EU treaty, or EU directives which had not been implemented in the UK within the required timeframe but which were sufficiently clear and precise, unconditional and did not give member states substantial discretion in their application).

This is because those EU laws would, absent any such further UK laws being enacted, automatically cease to have effect in the UK on the UK's withdrawal from the EU becoming effective.

The current relationship between EU law and UK law is principally governed by a UK statute (the European Communities Act 1972) which, among other things:

(i) provides for the direct application of EU regulations and the direct effect of those EU laws which are stated to have direct effect;

(ii) gives the UK government power to introduce delegated legislation to implement EU law generally; and

(iii) provides for the supremacy of EU law over UK law.

However, repealing the European Communities Act on its own would not avoid the need for the extensive review of existing UK laws implementing EU directives as described above. There have been some suggestions by "leave" campaigners prior to the referendum that the UK government should seek to repeal the European Communities Act prior to an agreement having been reached on the withdrawal arrangements and future relationship of the UK with the EU, although this would be a politically charged move.

If the Norwegian model were adopted, however, EU law relating to the free movement of goods, services, capital and persons would be likely to continue to largely apply in the UK.

If the UK were not a full participant in the single market, the ability of EU nationals to work in the UK, or the ability of UK nationals to work in the EU, would likely be affected

In a total exit, EU nationals would lose the automatic right to work in the UK, and UK nationals would lose the automatic right to work in the EU, subject to transitional arrangements which would presumably need to be put in place for an interim period. New immigration rules would therefore need to be implemented (i) in the UK in relation to EU nationals and (ii) in the other EU member states in relation to UK nationals.

If the Norwegian model were adopted, as part of having full access to the single market, the UK would likely continue to be bound by the EU treaty principle of free movement of persons, which would continue to enable EU nationals to work in the UK without requiring authorization.

If the Swiss model were adopted, the UK would need to enter into an agreement with the EU setting out the extent to which EU nationals would have the right to work in the UK, and UK nationals would have the right to work in the EU.

There are two related areas which, as they are matters of UK national sovereignty, would not be affected in the same way as the right of non-EU nationals to work in the UK.

First, the current visa requirements for non-EU nationals to work in the UK would remain in place, although additional restrictions on immigration from outside the EU could be imposed by the UK government in any event, and to the extent that nationals of any country had the right to work in the UK as a result of a bilateral agreement between that country and the EU (e.g., Switzerland) that right would cease to apply and new arrangements would need to be negotiated between the UK and that country.

Second, the UK's current tax regime for individuals who are resident but not domiciled in the UK is not a creation of EU law and would not fall away as a consequence of the UK's withdrawal from the EU.

One of the areas of law potentially most affected will likely be the regulation of financial services

Those areas which will be potentially most affected will be those where the EU has embarked on its most significant harmonization efforts in recent years, in particular the regulation of financial services.

Unless the Norwegian model were adopted, the UK government would need to decide whether to retain, amend or repeal a number of significant pieces of EU financial services legislation, notwithstanding that many of these are Basel-based. These include, among others, the Capital Requirements Directive (CRD) IV and other aspects of the bank supervisory regime, the Markets in Financial Instruments (MiFID) II and other aspects of the investment firms' supervisory regime, the Solvency II Directive and other aspects of the insurance supervisory regime, the Alternative Investment Fund Managers' Directive (AIFMD) and other aspects of the alternative investment management supervisory regime, the cap on bankers' bonuses, the Prospectus Directive and the Transparency Directive and other aspects of the capital markets regime, and the European Market Infrastructure Regulation (EMIR) and other aspects of the derivatives regime.

In addition, unless the Norwegian model were adopted or the application of the Norwegian model had been specifically negotiated for a transitional period as part of the withdrawal arrangements, there would be no right for UK-authorized firms or individuals to provide financial services in the EU on a "passported" basis. Any non-EU financial institution currently using a UK-authorized person to provide financial services elsewhere in the EU would need to obtain authorization from an EU member state by either establishing an authorized branch in an EU member state or obtaining authorization for one of its subsidiaries in an EU member state. The impact of any loss of "passporting" rights would be more serious for some financial institutions than for others.

It is very difficult to predict the overall impact on the UK financial services sector as a whole because, irrespective of whether the UK remains part of the single market for financial services, there are other factors which have historically helped the development of the financial services sector in the UK (such as the availability of talent, support services and other infrastructure and the use of English as the global language for financial services) which will continue to be present.

Other areas of law which would potentially be affected include, among others: M&A and corporate law; capital markets; competition law; and tax. In each of these areas, the extent of the impact will depend on the model which is adopted for the UK's future relationship with the EU.

There is potential for contractual disputes to arise

While it is not possible to anticipate all of the events which may arise as a consequence of the "leave" vote, there may, in some cases, be circumstances which arise which cause parties to claim that provisions either excusing the performance of contractual obligations, or triggering a right to terminate contracts, are capable of being invoked. Any such issues will require careful consideration in light of the relevant contracts as a whole and the possibility that circumstances may continue to change rapidly.

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