HERBERT SMITH FREEHILLS

BREXIT: CHARTING A NEW COURSE

HELPING FMCG BUSINESSES PLAN FOR A POST-BREXIT FUTURE

BREXIT: CHARTING A NEW COURSE

Businesses with interwoven supply chains across the EU and beyond have already felt the effects of a weaker pound, with increasing costs of sourcing raw materials and packaging leaving some organisations no choice but to inflate consumer prices. Combine this with the uncertainty of tariffs, access to skilled workers, and regulatory change businesses in the FMCG sector need to start preparing now to mitigate risks and seize opportunities in the post-Brexit landscape.

Our experts believe that by carrying out assessments in a 'hard Brexit' scenario is an effective way for businesses to compare their current position from within the EU single market with a counterfactual position in which the UK trades with the EU and the rest of the world on the basis of World Trade Organisation (WTO) rules. From this baseline, organisations can see most clearly the potential impact of the possible changes and make a corresponding plan of action.

In the pages that follow we provide a comprehensive view of the implications facing FMCG businesses to enable a thorough analysis and assessment to help plan for a post-Brexit future.

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PRODUCT LIABILITY

At present, the principal UK laws on product liability and safety are based on EU Directives which do not have direct effect in Member States (hence the need for domestic legislation to bring them into force).

For example:

- The (UK) General Product Safety Regulations 2005 brought into force the EU General Product Safety Directive 2005. The Regulations make it a criminal offence to supply an 'unsafe' product and empower the authorities to force a producer to recall unsafe products.
- The (UK) Consumer Protection Act 1987 brought into force the EU Product Liability Directive 1985. This Act which makes producers strictly liable for personal injuries and property damage suffered by consumers due to defective products.

Because the Consumer Protection Act 1987 is UK primary legislation, it should be unaffected by the UK leaving the EU. The Government has said that the Great Repeal Bill will convert all EU legislation into domestic legislation, effectively making UK law the same as the EU Directives and Regulations in place at the date of Brexit. The EU is currently introducing new Regulations on product safety which will have direct effect in Member States and which are likely to come into force before the UK formally leaves the EU. One of these, the new EU Consumer Product Safety Regulation, will supersede the UK General Product Safety Regulations 2005 when it comes into force.

The likely effect of this will be that (i) the current UK General Product Safety Regulations are repealed when they are superseded by a directly effective EU Regulation; and (ii) the Great Reform Act will provide any further implementation of the Regulations requirements in to UK law. Another possible outcome is that the UK may simply enact into domestic law the new EU Regulation (which most likely will have been in force for some time before Brexit). This would provide certainty and stability for companies and consumers and avoid the additional bureaucracy associated with a mismatching regulatory landscape for producers of goods sold within and without the EU. Of course the Great Reform Act will not resolve every question; there will be issues as to how the Regulation should be interpreted as part of UK domestic law (purposively or literally, like a purely UK law) and as to the assignment of the roles of the EU Commission or other EU bodies.

WHAT TO DO NOW:

- Understand the regulations that your company complies with across its supply chain – whether these derive from UK law, EU law or otherwise.
- Understand the areas where your portfolio products comply with minimum standards, and where you voluntarily exceed such standards.
- Continue to monitor industry press and consult your legal advisors – the regulatory landscape here is complex.
- Note consultations that the Government undertakes on these areas and engage.

INTELLECTUAL PROPERTY

The regulation and protection of intellectual property is a key concern for FMCG businesses. Protecting brand identity and product innovation, including through trade marks, patents, and trade secrets – will continue to be of critical importance.

We see the following as being critical issues:

Existing IP law will remain largely unchanged: We expect that, whatever future relationship the UK has with the EU, it is likely that the UK will provide for existing law to remain in place (save where there is a specific legislative requirement to change). That means IP law will continue to contain the concepts implemented from EU Directives, whether harmonising the law of Member States (e.g. as has been done with registered designs) or where novel rights have been introduced (such as protection of databases through database rights). However, rights currently defined as being EU-wide will need to be replaced and such provision will need to be in place prior to Brexit so there is no hiatus in protection through which local rights could be used to reduce the effect of any later substituted right or other challenges be allowed to arise to current rights which would have persisted but for Brexit. The Great Reform Bill/Act will not solve these issues without further specific provision, be that via statutory instruments under the Act or otherwise.

European Patents (EP), the Unitary Patent (UP) and the Unitary Patent Court (UPC): UK designated EPs will continue to apply in the UK and to be applied for at the European Patent Office. UK based businesses will be able to apply for UPs once they are available (once the UPC is established – see below) and these will cover all the participating Member States (i.e. all EU Member States except Spain, Croatia and Poland). Whilst the UK is still a member of the EU, the UP will also cover the UK, but once the UK has left the EU special arrangements would need to be made in order for the UK to continue to be part of the UP territory and thus the coverage of the UK post-Brexit is uncertain at best.

UPs will be enforced through the UPC as will European patents (EPs) which have not been opted-out of its jurisdiction. Those that have been opted out will continue to be litigated in national courts. The UK's recent announcement that it will ratify the UPC Agreement means that the previously expected delay in the UPC being established should no longer occur, with only Germany and the UK now needed to ratify to trigger the Agreement to come into force, since 11 other states have already ratified. The UPC will also be a forum for the litigation of existing and future EPs (of participating states) unless these patents are opted out of its jurisdiction. If the full ratifications required do occur, then a "sunrise" period for opting out EPs designated to participating EU states, is expected to commence in September 2017 according to the UPC Preparatory Committee in advance of the whole UPC and UP system going live in December 2017.

Again, however, the continued participation of the UK in this new court once the UK has left the EU is in doubt since reference to the CJEU is part of the process of the new court and in a previous judgment (Opinion 1/09) the CJEU appeared to countenance the UPC only having jurisdiction over EU Member States. Leading Counsel's Opinion commissioned by Intellectual Property Lawyers Association (IPLA) (of which we Herbert Smith Freehills LLP is a member) along with other IP representative groups, found that there were ways in which the UK could continue as a participant in the UPC but much would depend on whether the CJEU accepted the involvement of a non-EU state. There is therefore uncertainty over the continued application of the UPC's jurisdiction to the UK post Brexit. Transitional arrangements would need to be put in place to deal with any litigation that was on-going at the date of Brexit if the UK were no longer to be able to participate.

We can expect there to be concerted efforts to find a solution to these problems, given the perceived importance of the UPC to protecting innovation and R&D across Europe for business.

Once the UPC has "gone live", UK businesses with UPs and EPs will still be able to use the UPC for enforcement in other EU participating countries even if the UK subsequently leaves the EU. However, given these concerns and concerns at how the UPC will operate in the early years, some patent proprietors will choose to opt-out their current European patents from the UPC system (and any coming to grant in the transitional period of 7 years). As a result, business is still likely to pursue litigation in countries across Europe (including the UK) outside of the UPC system.

Trade marks: In order to maintain the status quo in relation to EU trade marks (EUTMs) - which will no longer cover the UK once it has left the EU - it is expected that provision will be made to provide an equivalent right in the UK with the same specification, priority date and term as the EU level right previously. The Great Repeal Bill will not protect these rights without further provision being in place from Brexit-day-one. Trade mark proprietors should consider in the meantime supplementing their protection, by applying for UK national trade marks for their key brands. UK national trade mark registrations will not be affected by Brexit.

INTELLECTUAL PROPERTY

Designs: Design legislation was harmonised at EU and national level when EU design rights (registered and unregistered) were introduced, so the loss of the EU level rights will not have much impact on the criteria for (or extent of protection of) new designs in the UK, especially since the UK already had its own unregistered design right (which persists and which has a longer term than the EU equivalent). However, where proprietors have EU level protection but not UK national protection for registered designs, some transitional arrangements will be required from Parliament to ensure that these rights are not lost in relation to the UK (since the UK will no longer be in the EU which is the territory by which these rights are defined). Protection via Community unregistered design will also be lost in the UK and it looks likely that products will need to be launched in the EU to qualify for this right post-Brexit. In relation to new designs, UK registered design should be obtained alongside Community registered design rights to provide protection in the UK post-Brexit. For older designs this may not be possible due to novelty requirements. The international registration of designs via the Hague Agreement, to which the EU is a signatory (but not currently the UK), will be possible once the UK has acceded. This was already planned pre-referendum, the UK Government's response to a consultation in January 2016 being that the UK would join the Hague Agreement before the end of 2016, although this has yet to take place.

Geographical Indications: Where rights have been created via EU Regulations such as Geographical Indications (GIs), these will either need to be negotiated to continue until expiry (with no new applications) via a transitional period or will need fresh legislation to provide the equivalent right in the UK. A reciprocal protection for goods being sold in the EU by third parties misappropriating the GI will need to be negotiated to provide sufficient protection for UK products currently protected across the EU.

Data privacy: The General Data Protection Regulation (GDPR) will apply from 25 May 2018, before the UK is likely to exit the EU. As a result, the UK Government has confirmed that the GDPR will apply in the UK, at least for a period of time before exit, and possibly after exit, in accordance with the so-called Great Repeal Bill. Post-Brexit, if the UK is no longer part of the EEA, it will not be required to follow the GDPR but, in reality, it is unlikely that the UK would stray far from the principles of the European regulation regardless of the form of Brexit undertaken.

Trade Secrets: The Trade Secrets Directive adopted recently is due to be implemented into national law across EU Member States by 5 July 2018. Although the proposed changes required are minimal for the UK, the UK may still decide to implement the Directive before 2018, to ensure a strong, harmonised playing field for protecting innovation and investment across Europe. Whether or not this implementation occurs, businesses with operations across Europe will wish to establish systems of protection and practice amongst their employees to ensure certainty and consistency of approach in the way they are able to respond to the challenges of safeguarding their critical trade secrets, meaning that the new Directive will still be essential reading.

Labelling: Products will still need to comply with CE-marking and other specific regulations, where their intended market is within the EU. We expect UK regulations to continue to meet EU requirements in order to ensure easy access to other EU markets.

Territory: Licences and other IP agreements using territory references such as EU or EEA will need to be reviewed to ensure that the UK (if it becomes a non-EU and non-EEA state) continues to be covered, and that there are no other territorial implications. Future contracts being entered into will need thought as to their intended coverage.

Definitions of "intellectual property" in documents and contracts: These definitions may need to be revisited to check that they cover all "new" provisions put in place to cover rights previously held on an EU-wide basis.

Exhaustion of rights: The rule of "exhaustion of rights", which provides that goods placed on the market in one part of the EU cannot be prevented from circulating freely within the EU and hence IP rights cannot be used to prevent the movement of goods across EU internal borders, would fall away in relation to the new UK/EU border and the use of seizure procedures via Customs and Excise may thus come to the forefront, unless such free movement of goods provisions are retained in any future relationship between the UK and the rest of the EU. This could have a significant impact upon parallel imports from the EU into the UK, particularly in the FMCG sector where such imports are widespread.

WHAT TO DO NOW:

Register national UK rights in parallel to your current EU-wide rights where possible (e.g. UK trade marks, UK registered designs (for new designs and those within the grace period) and UK plant breeders' rights).

- Continue to file national or European patents designating the UK.
- Continue to review your EP portfolio to decide whether to opt-out current EPs from the UPC system; things will move quickly as soon as Germany and UK's ratifications are in – a sunrise period for opt-out may become available September 2017, and late 2017 is looking like a reasonable start date if the final ratifications are not further delayed.
- Review all IP agreements for those with territories defined as "EU" and consider whether the definition of intellectual property will cover any future changes introduced to provide for the loss of EU-wide rights in the UK or whether licences will no longer be effective if EU-wide rights are lost.
- Continue to develop trade secrets policies and procedures in compliance with the Trade Secrets Directive to ensure smooth operations across Europe.
- Note any consultations the Government undertakes on intellectual property rights and the replacement of EU level rights (such as database rights and SPCs in addition to those mentioned above) and engage in these consultations.

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EMPLOYMENT AND MIGRATION

Until the UK leaves the EU, all EU employment law will continue to apply as before. After Brexit, employment rights which are not based on EU law – e.g., unfair dismissal, statutory redundancy pay, the national minimum wage, and most trade union legislation - will be unaffected by Brexit.

However, there are some key employment law rights which are derived from EU legislation, and FMCG businesses with employees in the UK will therefore face an inevitable period of uncertainty as to whether these rights will be retained in the longer term, either because a commitment to retain them is included in the Brexit deal negotiated, or (if the UK negotiates complete freedom to set its own employment and immigration laws) because Parliament chooses to retain them in the same or an amended form. In the short term, the Prime Minister has announced that existing workers' rights will be guaranteed during her premiership.

RIGHTS DERIVED FROM EU LAW:

- The majority of employment rights currently derived from EU Directives have been implemented as primary legislation (e.g., protection from discrimination) or secondary legislation (e.g., rights relating to working time, agency workers, TUPE, European Works Councils, and collective redundancy consultation). Where these rights are embodied in primary legislation - such as the Equality Act 2010 - they will remain in force unless and until the legislation is repealed. Rights under secondary legislation made under the European Communities Act 1972 will fall away automatically on the repeal of that Act but the Government has committed to replicate existing rights as part of the Great Repeal Bill due to be introduced in the next Queen's Speech in Spring 2017. The Government has stated that existing employment rights will be protected and incorporated into UK law as part of the government's Great Repeal Bill, including rights derived from CJEU decisions that may not be explicitly set out in EU legislation
- In the longer term, even if the UK does negotiate a deal involving freedom to set employment laws, there is unlikely to be a wholesale sweeping away of EU-derived rights, given the opposition this would face politically. More likely is a gradual tinkering around the edges, perhaps to row back on unwelcome rulings of the European Court of Justice in a number of areas.
- The most likely targets for substantial change, if that is permitted by the UK's deal, include the Working Time and Agency Workers Regulations. These have been heavily criticised as being overly burdensome for businesses and could be abolished or amended, creating opportunities and efficiencies for UK FMCG businesses.
- Depending on the terms of the Great Repeal Bill and associated legislation, FMCG employers may also face a period of uncertainty as to whether UK employment tribunals and courts will continue to apply decisions based on rulings of the CJEU; much-litigated issues such as holiday pay rights could be re-opened, making the legal position unpredictable until suitable cases are decided by the UK courts.

Freedom of movement: One of the most important areas for negotiation between the UK and EU, and one of the most politically sensitive topics, will be the extent to which freedom of movement of people between the UK and the post-Brexit EU is maintained. Any restrictions here would have significant implications across FMCG companies and their supply chains, including the agricultural sector, where many businesses are heavily reliant on seasonal workers or non-UK workers more generally.

A number of the possible arrangements, including membership of the European Economic Area or a Free Trade Agreement similar to the Swiss model, would require free movement to be continued and therefore cause minimal disruption. However, this is unlikely to be acceptable politically, and the UK is likely to seek to negotiate a new type of arrangement involving a more restrictive immigration and visa system. If this were negotiated, it would require a period of significant re-adjustment, and potentially restructuring, to address new staffing models.

As yet, it is still unclear what the position will be for current migrants. The extent to which UK nationals can live and work in the EEA will also be affected.

WHAT TO DO NOW:

- Consider the EU/visa status of key personnel and the implications of any restrictions on their right to work in the UK or within the EU on your critical functions.
- Multinational FMCG companies which have set up European Works Councils under UK legislation may need to develop contingency plans. Depending on the terms of the Brexit deal, EWCs may no longer be mandatory in the UK, or an EWC agreement not governed by the laws of an EU jurisdiction may no longer be compliant with the EWC Directive.
- Continue to monitor industry and political press. Consult your legal advisors regarding changes to employment legislation, proposals on migration and any consultations that the Government undertakes in these areas.

M&A ACTIVITY

The impact of Brexit on M&A in the consumer sector will depend to a significant extent on perceptions of the effect of Brexit on the UK's economy and on consumer confidence, and on expectations as to the ultimate trade settlement between the UK, the EU and the rest of the world post-Brexit.

This is likely to affect - in differing ways amongst products and segments - the competitiveness of UK FMCG exports, the cost of FMCG imports into the UK, and the burden on FMCG firms in adjusting to the post-Brexit regulatory reality. All of this will be relevant to valuations of FMCG firms, views on the potential upside in particular FMCG businesses, and the complexity of executing FMCG deals in the UK (for example, the extent to which a cross-Channel transitional arrangement may be required).

These outcomes are at a very early stage. In the six months since the result of the Brexit referendum, the greatest impact on M&A activity in the UK FMCG and retail sectors appears to have arisen from the devaluation of the pound following the referendum result. For example, this may have been a factor in the acquisition by South Africa's Steinhoff of the UK's listed Poundland, a discount retailer. The impact of currency movements is particularly relevant to FMCG businesses, where consumer sentiment can be quickly affected by price increases or perceived "shrinkflation" – for example, the publicity in relation to Unilever and Tesco's discussion of the pricing of Marmite and other products, and the response to Mondelez' decision to change the design of Toblerone bars.

As such, in the medium term we expect M&A levels to be affected by the uncertainty around the scope of the Brexit settlement, at least until the UK Government provides further clarity on its intentions and exercises the withdrawal right in Article 50 of the Lisbon Treaty. M&A will of course remain a key part of many firms' strategy, and we expect that many firms will continue to pursue strategic acquisitions or divestments rather than "wait and see" and run the risk that their competitors beat them to attractive opportunities. The impact of Brexit may also lead to a greater number of opportunistic deals becoming available, for firms that are particularly affected by Brexit (or which are particularly well-placed to address its implications).

In the longer term, bilateral trade deals (for example, with countries in developing Asia) could improve the UK's competitiveness and drive consumer demand, making UK FMCG firms attractive targets – and more willing to invest in outbound or domestic M&A. We also expect the following factors to be relevant:

- although non-UK lenders may be less willing to fund investments and capital expenditure in the UK, particularly where these are larger deals which rely on European debt syndication markets to allow transaction risk to be spread over a wider pool of syndicated lenders, it is expected that UK banks will remain keen to lend to fund acquisitions and fixed capital expenditure projects;
- the drop in the value of sterling will have different implications for those UK FMCG companies that have significant earnings in sterling compared to those who do significant earnings in other currencies but report in sterling – reduced earnings for the former group may make them vulnerable to opportunistic inbound M&A, whereas increased earnings for the latter may open up previously unaffordable opportunities; and
- the depreciation of the pound may create well-priced domestic opportunities for UK investors whose own businesses are less exposed to consumer confidence.

COMMERCIAL DISPUTES

Brexit will affect the landscape for commercial disputes in the UK and Europe, both in the short and the longer term. The below contains a list of immediate action points for the months to come.

Counterparties may look for grounds to terminate or renegotiate their contracts, contracts which predate Brexit, or indeed which predate the announcement of the Brexit referendum, may not cater expressly for commercial adjustments which result from the UK's ultimate departure from the EU. Changes in international trade law as applicable to trade between the UK and the EU – for example, the imposition of any tariffs – may make contracts for the supply or distribution of FMCG significantly more expensive to perform. In this context, parties may look for grounds to terminate or renegotiate newly onerous contracts – for example, parties may focus closely and seek advice on MAC clauses, provisions for change of law, and periodic repricing provisions as means of applying pressure to obtain a more favourable deal.

The incidence of "economic breach" may rise: in the absence of any express or implied terms which enable a party to apply termination or renegotiation pressure, parties may consider that it is cheaper to cease to perform some contracts – and face an action for damages – than continue to perform on very unattractive terms. This may be particularly true in the case of FMCG supply contracts with limited or no minimum purchase terms.

English law will remain the leading governing law for commercial contracts globally: English law will largely be unaffected by whether the UK remains part of the EU or not. It will continue to be selected by businesses for certainty as the choice of law for very many commercial arrangements.

The English Courts will remain a centre of excellence for determining disputes governed by English law and will remain a popular forum for high value and complex disputes. This is given the quality of the judges and robustness of the process, as well as the innovations the courts have been developing, such as: (i) trial within 12 months as part of the shorter trial scheme; (ii) costs are kept in check through budgeting; and (iii) recovery of costs from the losing party is increasingly assessed summarily after trial with a lump sum award. The UK will remain competitive on all fronts whether inside or outside of the UK. UK court judgments will remain readily enforceable within the EU or globally.

Pan-European enforcement strategies remain important: Current or future pan-European litigation strategy will still involve multiple courts and supra-national management of disputes. It will still be critical to have advisers who are expert in handling multiple cross-border disputes and managing local lawyers in every jurisdiction within Europe or beyond.

WHAT TO DO NOW:

- Plan for an analysis your existing contractual framework to stress test your key contracts for the potential implications of Brexit – for example, any potential for increased costs which you will be unable to resist.
- Analyse which contracts you may wish to terminate depending on the effect of Brexit upon your business, and assess how you would replace those contracts or otherwise mitigate the effect of their termination.
- Rigorously monitor counterparty performance to assess whether any of your business partners are contemplating changes to their own contractual frameworks, in a manner which could affect your business.

COMPETITION LAW

Although the Competition Act 1998 adopts the same approach as EU Competition Law, the UK has maintained a different regime for assessing mergers and carrying out market investigations under the Enterprise Act 2002.

Both these Acts will remain in force in the UK, and EU competition law and the laws of EU Member States will continue to apply in the continuing EU. What will probably be lost is the jurisdictional allocation of cases and merger control between the UK and the EU, and EU law will cease to be a part of UK law.

Paradoxically, this could result in double jeopardy for businesses: an infringement of competition law affecting the EU and the UK can be investigated by both, and lead to fines by both, whereas previously the EU would probably have taken sole jurisdiction. The same applies to large international mergers.

While significant emphasis was placed on the potential for business-friendly deregulation if there were a Brexit vote, it currently seems unlikely that competition law rules within the UK will be relaxed, with the possible exception of certain state aid rules. A more realistic outcome is that although UK competition laws will continue to reflect EU competition laws, there may be some divergence in the medium term, which may increase the complexity of compliance for businesses operating cross-border in Europe. By way of example of early divergence, the UK Government has announced its intention to extend the public interest test on mergers under the Enterprise Act to include a national security review of investors in the UK's critical infrastructure.

One area where Brexit may have an impact in the next few years is in relation to the European Commission's Digital Single Market initiative, which aims to open up competition across the EU in digital markets through a series of initiatives that seek to remove practical obstacles to e-commerce. These initiatives include improving consumer protection rules to address the reluctance of Europeans to shop cross-border, addressing issues with high parcel delivery costs, simplifying VAT rules for businesses and reviewing rules on IP and satellite/cable transmission.

From a competition perspective, the Commission is seeking to enhance options available to prevent geoblocking – the practice whereby retailers divert customers to a particular website on the basis of the nationality or residence of that customer, or block customers from accessing certain websites for the same reasons, allowing retailers to charge consumers different prices in different countries. While clauses in distribution agreements which require geoblocking may be anticompetitive under EU law, a Commission survey found that the majority of geoblocking practices in relation to consumer goods (excluding digital content) arise from unilateral practices and therefore probably fall outside the scope of competition law (except where the supplier is dominant). The Commission therefore proposed a regulation prohibiting the practice of geoblocking.

In the currently anticipated scenario where the UK exits the Single Market, the Digital Single Market initiatives would not apply to UK-based e-commerce businesses and the UK would find it difficult to unilaterally adopt measures with equivalent cross-border effect. The commercial impact of this will depend on each business' perspective.

WHAT TO DO NOW:

FMCG firms should analyse how the changes outlined above may affect their businesses, in order then to assess any risks and opportunities and identify the appropriate course of action. For example:

- M&A activity may be affected by double jeopardy, but not until the UK actually leaves the EU, and then only depending on the transitional arrangements;
- certain brand-owners and online retailers may welcome the ability to prevent customers in the UK from purchasing from other EU based online retailers, and to prevent EU customers from purchasing from UK retailers;
- however, given that UK business is a significant online exporter to other European countries, certain retailers may also see a significant reduction in online export sales to EU consumers if they find that brand-owners start to impose restrictions on online retailers' ability to sell outside the UK, with business being diverted to websites with an EU presence. This difficulty could potentially be compounded if products shipped from the UK to the EU were subject to additional duties and tariffs;
- any businesses which have a presence in the remainder of the EU will continue to have to comply with all applicable EU laws within the EU, including regulations arising from the Digital Single Market initiative. If Brexit does result in additional duties and tariffs on UK products being sold into the EU, it may be more economical for such businesses to move a greater part of their supply chains into an EU jurisdiction post-Brexit; and
- UK-based SMEs with substantial online retail export businesses may be the most exposed to missing out on the benefits on offer as part of the Digital Single Market reforms, which were intended to increase consumer confidence in cross-border e-commerce.

TRADE AND CUSTOMS DUTIES

The UK is currently part of the EU internal market, which is one of the most advanced trade areas in the world. It provides for the free movement of goods, services, labour and capital, which entails the abolition and banning of all discriminatory trade barriers (such as tariffs and quotas) and the continuing removal of non-discriminatory or de facto barriers through various processes such as harmonising legislation, mutual recognition and 'passporting' for the services sector.

The EU internal market is also a customs union, which means that all EU Member States apply a common customs tariff to all goods imported from outside the EU, irrespective of the Member State where the goods enter the EU. By contrast the EEA, including Norway, Iceland and Liechtenstein as well as the EU countries, is a "single market" free trade area without customs or other barriers for goods produced in the territory of those countries, but third country origin goods (eg. machinery manufactured in the USA) remain liable for duties when imported from eg Norway (EEA only) to Sweden or Denmark (EU) or vice-versa.

On 17 January 2017, Theresa May announced the UK would no longer be a member of the internal market following its exit from the EU and would not seek to remain in a customs union with the EU. However, she expressed the hope that the UK and EU could agree a bespoke free trade framework by the time the UK exits the EU which could then be implemented over a transitional period. While May expressed desire for a free trade deal with the EU, she also made clear that, for the UK, no deal would be better than a bad deal.

On 17 January 2017, Theresa May also announced the UK's intention to negotiate and secure free trade agreements with key partners around the world.

TRADE BETWEEN THE EU AND THE UK

The implications of Brexit for the FMCG sector will depend on what trade arrangement with the EU will replace its current access to the internal market.

If there is no free trade agreement in place when the UK leaves the EU (or agreed status quo transitional arrangements), the trade relations between the EU and UK will fall back to the WTO regime. This means, *inter alia*, that tariffs will be charged at WTO most favoured nation ("MFN") rates on goods traded between the EU and the UK (often referred to as "hard Brexit"). During the period before any bespoke agreement takes effect (whether agreed in the context of Brexit negotiations or at a later point in time), UK exports would become less price-competitive in the EU compared to exports between EU Member States which face no tariffs, and EU imports to the UK would likely become more expensive. The implications would differ from sector to sector as the tariffs vary in composition and significance depending on the nature of the goods. See our publication Trade Post-Brexit: charting a new course.

Under a UK bespoke free trade agreement, the EU and UK would, among other things, be able to apply zero duty to each other without the need to extend duty free treatment to other WTO countries. However, to the extent that the UK does not agree a customs union with the EU, rules of origin will apply to goods entering the EU via the UK. The rules of origin determine where the goods originated in order to decide the relevant tariff. Broadly speaking, there are two main categories under these rules: goods wholly obtained or produced in a single country and goods which are sufficiently worked or processed to qualify as originating from the exporting country.

Enforcing the rules of origin would result in customs checks, and the cost and administrative burden of dealing with this process would be an extra burden on UK business involved in export to the EU and vice versa. It would also mean that the UK's non-EU trading partners would be unable to take advantage of the UK as a point of entry for the whole of the EU.

Any products exported to the EU will also need to comply with all mandatory EU technical rules and standards, which will involve testing and certification of conformity.

TRADE BETWEEN THE UK AND THE REST OF THE WORLD

Existing agreements

In addition to its tariff-free access to the EU market, the UK also currently benefits from either tariff-free or reduced-tariff access to the markets of third countries with which the EU has concluded a preferential trade agreement. There are currently around 50 preferential trade agreements in place between the EU and third countries. The UK is party to these agreements by virtue of its EU membership. Following a hard Brexit, the UK may not be able to benefit from these preferential trade agreements, and UK exports may then attract that third country's standard or MFN customs tariffs. The UK will therefore need to assess which of these agreements remain relevant and should be renegotiated. UK

negotiations with third countries cannot formally start until the UK has left the EU.

Many of the EU preferential agreements are 'mixed agreements' which means they contain provisions relating to the EU's exclusive powers as well as to areas reserved for the Member States. Mixed agreements are concluded between third countries and the EU as well as the EU Member States. It may be possible for the UK to agree with the relevant third country on 'rolling-over' those mixed agreements, but that may depend on the specific terms of each of these agreements.

New agreements

The UK's exit from the EU and any customs union with the EU will mean that it will be free to negotiate trade agreements with third countries. These would need to comply with the WTO's rules for free trade agreements and be notified to the WTO. Negotiating free trade agreements can take time and the UK will have to decide which agreements it wants to prioritise, based on trading patterns and resources.

WHAT TO DO NOW:

- Ascertain the countries of origin for products and raw materials/semi-finished products incorporated in your final products.
- Analyse the supply chains for each product line.
- Analyse the impact of tariffs as products and their inputs move around, not just between the UK and the EU, but around the world.
- Consider whether changes to supply chains or places of production could reduce the incidence of increased tariff barriers.
- Consider the time-line for action to achieve these reductions and related steps that may need to be taken (eg in relation to employees or production and storage facilities).

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AGRICULTURE AND FISHERIES

The EU is the UK's biggest export market for food and drink products, but the UK is an overall net importer from the rest of the EU and from many other countries. Overall, the UK is about 76% self-sufficient in respect of food. FMCG businesses may be affected by changes in this area in a number of ways.

AGRICULTURE

CAP: to the extent that manufacturers own their farms themselves, they will be affected by changes arising from the UK becoming free to set its own policy on agricultural subsidies. This is a devolved area of legislation, so effects may be different in Wales, Scotland, Northern Ireland and England. It is thought that the devolved administrations will be less willing to make changes, while policy for England may, after a relatively short transitional period (to 2020), move further away from direct income support towards giving support for more general environmental or rural policy objectives. This may result in a rather abrupt move for some farmers away from income support, which would place considerable pressure on the economics of the industry, in addition to the trading pressures it will face if WTO customs duties become payable.

Alternatives to income support include payments to protect food security, insurance schemes and more support for environmental schemes, but a downward pressure on support could be expected.

Prices: A large number of factors will be relevant to the price of agricultural products in the UK and will affect the cost to manufacturers for key ingredient to their products, whether produced in the UK or elsewhere. Assuming that there is no UK-EU transitional arrangement or long term free trade agreement, factors include:

- the relationship of the £ to the US $ and the € where products are traded largely in one of those currencies;
- the tariff barriers agricultural produce would face on import: for example the EU and the UK could begin the apply the common customs tariff rates to goods traded between them and where the UK falls out of an EU/third country free trade agreement, trade between the UK and that third country in both directions would be subject to tariffs. The UK does control the rates of tariff that it sets, but WTO rules prevent the UK differentiating the rates it applies to countries with whom it does not have a free trade agreement. The EU and third countries are similarly constrained in the tariffs they charge the UK so long as there is no applicable free trade agreement;
- the costs and delays arising from complying with phytosanitary rules and other non-tariff checks on goods traded between the UK and the EU. These have historically proved at least as great an obstacle to trade as tariffs;
- the extent to which VAT or other sales taxes will apply and at what rates;
- the cost of labour in the event of severe restrictions on the right to reside or work in another country – particularly if this were to create a labour shortage in the UK;
- the cost of transport if priced in a stronger currency;
- the cost of equipment and machinery;
- potential partial loss of EU level intellectual property rights such as EU trademarks and Community Plant Variety Rights, although the UK should be able to safeguard equivalent rights; and
- loss of recognition of protected food and drink names: the UK has 73, including Cornish pasties and Melton Mowbray Pork Pies, and the EU very many more, Champagne and Parma ham being among the most fiercely protected in the courts.

However, there is little consensus whether overall the combination of these effects will increase or decrease prices at the level of manufacturing or retail, and where this effect will be felt most strongly.

Other Barriers: It is possible that, in the absence of an agreement, it may become impossible or uneconomic to trade some products between the EU and the UK or between the UK and third countries which have a free trade agreement with the EU from which the UK becomes excluded. Though factors affecting pricing are likely to be the primary cause, in some cases non-tariff barriers could prove to be absolute: the early judicial history of the EU is full of cases that broke down these barriers, ranging from the banning of drinks because their bottles were too like one with local protection, to rejection of products on the grounds that their production did not meet local environmental standards. On the whole these rules do not now affect trade between the UK and any EU country because they work to the same rules, but these restrictions could arise again. The same applies between the UK and third countries which have a free trade agreement with the EU: for example the EU-Chile free trade agreement has gone into great depth in dealing with the elimination and limitation of this sort of problem, but those rules may cease to apply between the UK and Chile.

FISHERIES

The UK fishing industry has long fretted that the Common Fisheries Policy, being based on an historical assessment of the relative strength of different countries, has not given the UK fleet sufficient share of the catch in UK waters nor sufficient control over those waters or of the ownership of UK registered boats, as well as doubt about the EU's approach to maintaining sustainable fishing stock.

Financial Support: According to a House of Commons paper EU and UK matched funds to support the fishing industry amount to €486.2m but the industry only has about 12,000 people directly employed in fishing, although more will be employed in related activities, and it must be questionable how much of this will be retained after Brexit.

Exclusive Economic Zone: The precedent of Norway, Iceland and Greenland suggest that the UK could obtain full control of its waters in the 12/200 mile zone around its coast ("EEZ"). The waters within 12 miles of a country's coastline are largely subject to national fishing rights, subject to some historic exceptions. It is questionable, however, whether this will lead to an increased quota for the UK fleet in those waters (as some historic fishing rights may be safeguarded by principles of international law) or preserve an equally favourable deal for UK fishing in the EEZs of the EU and of Norway, Iceland and other third countries.

Imports and exports: About 80% of UK landed catches are exported, with the EU as by far the largest importer. In addition some 20% of the total catch of the UK Fleet is landed directly in the EU. However the UK also imports fish in very large amounts (about 70% of sales value in the UK), with the majority coming from outside the EU. This reflects consumer preferences and the distribution of species. In the absence of agreement with the EU and countries with which the EU has a free trade agreement, it is likely that input costs and the fish trade between those countries would face tariffs and a number of the issues that affect the price and tradability of agricultural products as outlined above.

How this will affect those in the FMCG sector whose inputs include fish will ultimately depend on the deal done with the EU and other key states, particularly those such as Iceland and Norway with adjacent waters, and whether these cause any disruption (such as the famous "Cod Wars"). Overall the picture suggests that prices may rise.

WHAT TO DO NOW:

In addition to the steps mentioned in relation to trade and customs:

- Identify any new phytosanitary barriers which may disrupt supply chains or export markets.
- Identify any risks arising from loss of intellectual property rights or protected food and drink names.
- Consider any obstacles arising from restrictions on migrant labour.
- Consider whether any scarcities will arise from the changed rules for agricultural products or fishing.
- Consider cost implications of reduction or removal of EU subsidies.
- Plan to mitigate these problems, including examining alternative sources of supply, if appropriate, and registering additional UK IP rights, where available.

TAXATION

Several of the UK's tax laws are derived from or imposed by EU law. There is therefore the potential for upheaval when the UK leaves the EU: (i) because lacunae emerge where there used to be directly applicable EU law; (ii) because the UK courts begin to interpret EU-derived law differently; or (iii) because the UK Government sees an opportunity to depart from the status quo and changes the law or interprets it differently.

VAT

Apart from changes to tariffs that may result if the UK leaves the single market (as discussed above), the biggest potential changes to the current position that could affect the FMCG sector are likely to be changes to the VAT system.

Although VAT stems from EU legislation in the form of the VAT Directive, the VAT laws in the UK are part of the UK's domestic legislation. Unless repealed by Parliament, which is very unlikely, these laws will therefore continue to apply when the UK leaves the EU. The impact of decisions of the Court of Justice of the European Legislation ("**CJEU**"), which is responsible for interpreting EU-wide VAT rules, will, however, change, as the UK courts will no longer be required to adhere to the CJEU's decisions.

Aside from the possibility that the VAT laws may be interpreted differently when the UK courts have unrestricted jurisdiction to interpret them, the other major change with respect to VAT is likely to be in the way that the VAT laws apply in practice. One example of this which could be relevant to companies active in the FMCG sector is the treatment of cross-border supplies to and from members of the EU. Whereas these were treated as "acquisitions" and "despatches", they will need to be treated as "imports" and "exports" when the UK leaves the EU. This is likely to mean that the way in which such supplies are reported and the related VAT accounted for will change.

Another possible change in the application of VAT laws could arise if the UK Government decides to change the rates of VAT or the scope of any of the exemptions from VAT. At present, there is no indication of the UK Government's intentions in this regard.

WITHHOLDING TAXES

The EU has implemented a number of directly applicable tax laws that will cease to have effect when the UK leaves the EU. Among these are the Parent-Subsidiary Directive and the Interest and Royalty Directive. The upshot of this is that EU subsidiaries of UK companies will not be able to rely on these Directives to exempt from withholding tax the dividends or interest they pay to their UK parents. While this is not an issue in every EU jurisdiction, there are several that impose withholding taxes on dividends or interest. In these cases, relief may be available under applicable tax treaties with the UK, although not all such treaties reduce the rate of withholding to 0%.

"The recent spate of State Aid cases related to tax concessions have caught the public attention: these are driven by the EU Commission and based in EU law forbidding State aids that may distort competition."

Similarly, UK subsidiaries of EU companies may be required to withhold tax from payments of interest to their EU parents, the rate of withholding depending on the availability and terms of applicable tax treaties. The position as regards dividends paid by UK companies is likely to be less affected, as the UK domestic legislation exempts most dividends from withholding tax in any case.

As many FMCG businesses operate across the EU, these issues may necessitate some changes to group structures.

STATE AID

The recent spate of State Aid cases related to tax concessions have caught the public attention: these are driven by the EU Commission and based in EU law forbidding State aids that may distort competition. When the UK leaves the EU, there will (unless agreed otherwise with the EU) be scope for the UK Government to implement tax laws that previously it would not have since the Commission will no longer have a direct jurisdiction to challenge these. This could make the UK tax regime more attractive to multinational businesses. However, WTO rules designed to limit discriminatory subsidies will still apply and can be litigated between States (including for this purpose the EU customs union) in the WTO dispute resolution process.

WHAT TO DO NOW:

- Analyse the impact of likely changes to VAT rules consequent on the UK becoming a third country from an EU perspective.
- Cost and prepare for these changes.
- Consider whether the impact of changes to withholding tax may require adjustment of group structures in the UK and EU.
- Consider whether the UK offers any opportunities not previously available as a result of the strict EU State aid rules falling away.

"Aside from the possibility that the VAT laws may be interpreted differently when the UK courts have unrestricted jurisdiction to interpret them, the other major change with respect to VAT is likely to be in the way that the VAT laws apply in practice."

ENVIRONMENT

Environmental protection regimes in the UK and the EU have become highly entwined. The broad consensus is that EU membership has been beneficial for environmental protection in the UK.

At least 50% of UK environmental law derives from the EU, which has driven improvements in environmental standards, introduced uniform regulation within the EU market and promoted coordination between countries to tackle cross-border environmental challenges.

Separating domestic environmental law from its EU context could take many years, given the interdependency of the two regimes. Depending on nature of the final agreement for leaving the EU, there are two broad concerns. First, the UK Government has suggested it will keep all existing EU laws in place as at the date of Brexit, but this is not as simple as it sounds to achieve. Not all EU environmental law that is not already on the UK statute book can simply be cut and pasted easily into UK laws. Second, and more significantly, after Brexit environmental standards could be varied so as to make them less burdensome but correspondingly less effective. The attractiveness of that prospect will no doubt depend on the reader's viewpoint. Particular areas of EU regulation where the UK has struggled to comply such as air quality targets or water quality, or which are very burdensome such as areas of waste law and chemicals registration, may be early targets for reform.

Note also that the power to make environmental legislation is devolved to the regions – Scotland, Wales and Northern Ireland – and it is unclear how the UK Government will deal with the devolved powers when converting EU legislation into domestic law.

EMISSIONS

The UK is currently the second largest contributor to greenhouse gas emissions in the EU; it is unclear if the EU Emissions Trading Scheme ("**ETS**") will continue to apply to the UK following Brexit.

In the near future, there is some uncertainty whether a UK exit from the EU ETS would invalidate allowances already issued to UK participants under the scheme or whether they can be resold in the carbon market.

The UK's exit from the EU market is likely to lead to a fall in demand for carbon allowances. This could not only hinder regulatory efforts to control greenhouse gas emissions in the UK but also in the remaining EU Member States. In the UK's case, an alternative incentive mechanism would likely be required to enable the UK Government to meet the ambitious binding emissions targets set by the Climate Change Act 2008. This might take the form of the re-instigation of a domestic emissions trading regime.

ENVIRONMENTAL PRODUCT LIABILITY

Unless there is a significant reduction in volume of trade with the EU, it is expected that UK manufacturers, suppliers and distributors would in practice have to meet EU environmental products standards in order to continue trading in the EU single market. The relevant EU legislation includes regulations on eco-labelling, eco-design, detergents and cosmetic products.

CHEMICALS

FMCG businesses are required, where relevant, to comply with the REACH Regulation, which sets strict requirements on EU importers and manufacturers in relation to substances placed on the EU market. The UK will need to carefully consider how it will convert this regime into domestic legislation post-Brexit, in particular with regard to who the regulating body and equivalent of the European Chemicals Agency will be. Regardless of the domestic legislation to be implemented, those in the FMCG sector that manufacture and/or import into the remaining EU will still need to continue to comply with the REACH Regulations.

WASTE

A large proportion of the framework on the regulation of waste originates from EU law. The definition of "waste" is perhaps the most significant use of EU judge-made law, with what is and is not regulated as waste depending on a string of CJEU decisions. There is uncertainty with regard to the future interpretation of "waste" and whether this will continue to be in line with the EU purposive approach (resulting in little or no change to the current position), the English literal approach (which could have significant and wide-reaching effects), or a mixture of both. The UK Government will need to consider how this area of law will be dealt with and interpreted.

IMPLICATIONS

Although the plan announced by the UK Government is to maintain the legal status quo initially, industry groups (including in the FMCG sector) may want to consider before Brexit occurs what changes to EU derived environmental law that they would propose be made to redress regulation that disproportionately affects the industry or is ill-designed. The environmental provisions of any free trade deals which the UK Government is able to negotiate, whether with the EU or third party countries, will also be of interest to manufacturers and distributors as they emerge.

WHAT TO DO NOW:

- Keep an eye on how EU environmental law is transposed into domestic UK law in the "Great Repeal Bill" and, potentially, devolved legislation.
- Lobby the UK Government and the EU for your desired position on emissions trading post Brexit.
- Consider whether there are any areas where your business might be assisted if the UK or parts of it took an independent approach on some environmental issues.

"FMCG businesses are required, where relevant, to comply with the REACH Regulation, which sets strict requirements on EU importers and manufacturers in relation to substances placed on the EU market. The UK will need to carefully consider how it will convert this regime into domestic legislation post-Brexit, in particular with regard to who the regulating body and equivalent of the European Chemicals Agency will be."

PREPARING FOR BREXIT: HOW WE CAN HELP

We are working with numerous clients on the implications of Brexit for their activities. We have also collaborated extensively with other professional services organisations to provide holistic impact assessments and strategic advice, aligned with individual clients' objectives.

THE HARDEST FORM OF BREXIT AS A TOOL FOR BREXIT AUDITS

In its "hardest" form, hard Brexit means that there would be no new (or interim implementation) trade agreements in place between the UK and the EU at the time of the UK's exit. Such a scenario could take the UK abruptly from having one of the deepest sets of trade ties in both goods and services with the other 27 EU Member States to being in the same position as most of the EU's third country trading partners with whom no special trade agreement has been negotiated.

The benefits of membership of the EU include the free circulation of goods between members, without tariffs, customs formalities or other forms of border control. Members also enjoy wide-ranging rights to sell services without discrimination, for example by establishing operations anywhere inside the Single Market. A shared regulatory framework facilitates trade, with rights protected by EU law and enforced by EU and national courts.

Regardless of how likely the outcome is considered, carrying out assessments for this "hardest Brexit" scenario is the most effective way for businesses to compare their current position from within the EU Single Market with a counterfactual position in which the UK trades with the EU and the rest of the world on the basis of World Trade Organisation (WTO) rules. From this baseline, organisations can see most clearly the potential impact of the possible changes and make a corresponding plan of action.

The steps that we can assist clients with, either working alongside each other and clients or alongside client teams and their other advisors, can be divided up into the following three broad steps:

1. Analyse: diligence

Initial analysis or due diligence of Brexit-related risks and opportunities, establishes risk exposures and opportunities – a "Brexit audit". Issues affecting organisations may be general, they may affect an entire sector, or they may be idiosyncratic and only affect a specific business. For this reason, review exercises must be tailored for individual organisations to reflect their business activities and specific operating environment.

The focus of any review will be dictated by the nature of the underlying business but might include regulatory analysis (eg market access issues and deregulation opportunities), supply chain analysis (eg impact of tariffs and non-tariff barriers) and contract reviews (eg identification of problematical terms and contracting strategy issues).

2. Assess: strategic advice

The conclusions of this type of analysis allow organisations to assess identified risks and opportunities, calibrating their relative importance and likelihood, and to prioritise further action. Understanding the interdependencies and lead times (political, operational and regulatory) is crucial to the development of a phased and proportionate response.

3. Address: executing the strategy

As and when the time comes to take action to mitigate risks or seize opportunities, this may involve deploying arguments with Government (UK, EU and third countries) directly or through industry bodies to influence their approach based on prioritised analysis. On the operational plane it may mean strategic M&A, devising alternative legal structures, making changes to geographical footprint and workforce, re-assessing investment plans, revising compliance frameworks and so on.

We continue to use "hardest Brexit" as a downside case for analytical purposes together with upside cases based on the UK Government's declared objectives and sector-specific considerations.

Given the evolutionary nature of the Brexit process, any response requires an element of ongoing monitoring in order to sequence and trigger planned actions but also to regularly re-validate adopted strategies.

CONTACTS

Susan Black
Partner, London
T +44 20 7466 2055
susan.black@hsf.com

Joel Smith
Partner, London
T +44 20 7466 2331
joel.smith@hsf.com

Christine Young
Partner, London
T +44 20 7466 2845
christine.young@hsf.com

Lode Van Den Hende
Partner, Brussels
T +32 2 518 1831
lode.vandenhende@hsf.com

Andre Pretorius
Partner, London
T +44 20 7466 2738
andre.pretorius@hsf.com

Dorothy Livingston
Consultant, London
T +44 20 7466 2061
dorothy.livingston@hsf.com

Howard Watson
Partner, London
T +44 20 7466 2088
howard.watson@hsf.com

Philip Pfeffer
Partner, London
T +44 20 7466 2660
philip.pfeffer@hsf.com

Isaac Zailer
Partner, London
T +44 20 7466 2464
isaac.zailer@hsf.com

Richard Woods
Senior Associate, London
T +44 20 7466 2940
richard.woods@hsf.com

Rachel Montagnon
Professional Support Consultant, London
T +44 20 7466 2217
rachel.montagnon@hsf.com

Josh Lom
Associate, London
T +44 20 7466 2102
josh.lom@hsf.com

Julie Vaughan
Senior Associate, London
T +44 20 7466 2745
julie.vaughan@hsf.com

Kristien Geeurickx
Professional Support Lawyer, London
T +44 20 7466 2102
kristien.geeurickx@hsf.com

NOTES

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Accessing our deep global sectoral expertise, as well as our local market understanding, we help organisations realise opportunities while managing risk to help them achieve their commercial objectives. To keep up to date on developments in the post-Brexit landscape, navigate to

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