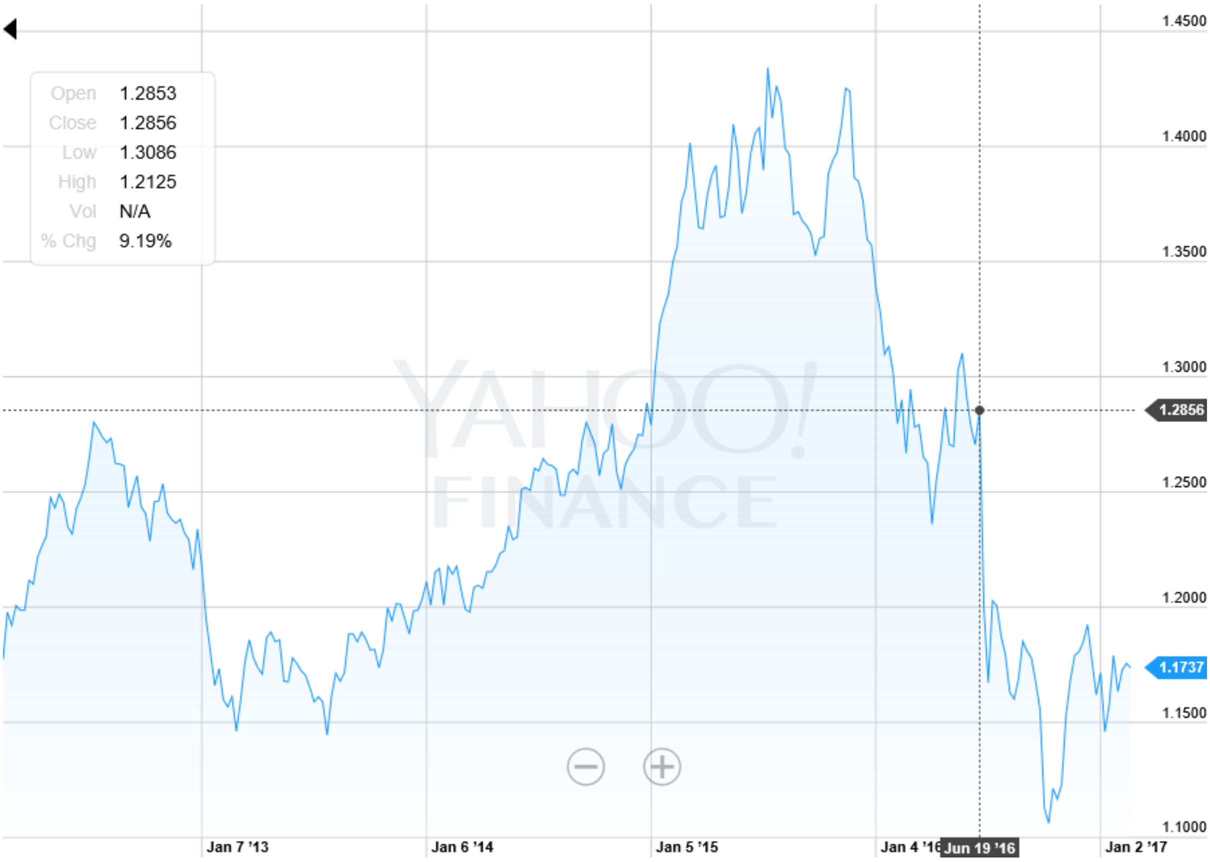
What a difference a day makes…

Following the UK's decision to leave the European Union on 23 June 2016 and the potential future deal the UK will strike with the EU, if any, the press has been full of commentary regarding the impact that this will have on UK businesses. In this article Phil Southall considers how some of these factors could impact on some matters that you may come.

There are significantly varying degrees of interest regarding how the next two years may impact the UK economy, and each commentator's ability to be able to reliably predict that impact. As I'm sure that you will all be aware, the hard or soft Brexit arguments are the cause of a significant divergence in opinion regarding the likely longer term effect.

However, the post-Brexit fall and continued decline of the Sterling exchange rates against both the Euro and the US$ are already influencing matters that I am aware of. The impact has potentially been exacerbated given that in the days immediately prior to the referendum market sentiment saw Sterling rise against both currencies, as can be seen on the graph below [Source Yahoo Finance], which may have influenced may companies' hedging decisions at that time:



For example, consider the takeover of a food manufacturer and distributer that imports ingredients from Europe. Insufficient currency hedging has now reduced its profitability by £1.5 million per annum from £4 million to £2.5 million. If that acquisition had been priced using a profit multiplier of 8 then, other things being equal, this potentially wipes £12 million off the value of the business.

At first you might think that the acquirer might be pretty distraught by this. However, the deal had been structured so that most of the consideration was to be deferred, and paid in the years after the transaction date. Moreover, the post-completion payments were to be assessed by reference to profits achieved following completion.

It was therefore the seller that was left with the proverbial egg on their face.

A similar example relates to a commercial agency dispute. The UK-based agent asserted that the agency had been terminated unfairly by the US-based principal, and sought to claim damages in respect of compensation due under Section 17 of the Commercial Agents (Council Directive) Regulations 1993. Simplistically, the loss was the loss of value of the commercial agency, which was assessed by reference to forecast future cashflows, over a number of years.

As can be seen from the graph below [Source: Yahoo Finance], there have been similar fluctuations of Sterling against the US $ since June 23rd.

In the absence of being able to predict future exchange rates with sufficient reliability, our report assessed the losses using an exchange rate of £1: $1.24, which was the prevailing exchange rate immediately before the date of the expert report. In contrast to this, the exchange rate prevailing on the date of the termination of the agency, which was £1: $1.57. Let us consider the impact of this on the damages that may be awarded.

If damages were both awarded and paid in US$, then conceptually this would be most akin to the value of the agency as at the termination date, albeit but for the unfair termination this value would have accrued throughout the life of the agency (and the agent could have converted it to Sterling if and when he wanted).

However, if, for example, the agency was value at $1.57 million at termination date, then if damages were awarded in Sterling, then the UK-based agent would receive £1 million using the exchange rate prevailing at that date.

Given the passage of time whilst legal cases were prepared, if the Claimant were to be awarded the Sterling equivalent of $1.57 million using the rate as set out in our report, then he would receive almost £1.27 million. This appears to be a windfall gain of almost £270,000 compared to what he would have received in Sterling as at the termination date.

Alternatively, if the Claimant was to receive £1 million, then this would now only cost the principal $1.24 million using the rate as set out in our report. Again, this appears to be a windfall gain of $330,000.

Consequently, the movement in exchange rates will significantly impact on either the agent or the principal depending on the award. Whilst this is always the case, the impact has been exacerbated by the magnitude of the movement in exchange rates.

Conversely, I am dealing with a claim whereby the claimant has sought to assess a historic liability that has accumulated in Euros over a number of years. However, rather than use the known historic exchange rate prevalent at the dates of the transactions, the Claimant sought to use a date in October 2016. Whether by accident or design, the exchange rate actually used in the letter of claim was the lowest daily exchange rate for 5 years.

As a direct consequence of this, we considered the Sterling value of the claim (which my client would end up paying as they did not hold cash in Euros) was significantly overstated, perhaps by as much as 30%.

The examples illustrate how it may be tactically advantageous for one party to expedite or delay proceedings in light of future forecasts in movements in economic factors, such as exchange rates, in order to influence a more advantageous settlement. Additionally, it is not uncommon for the relevant date for a valuation to be disputed in shareholder disputes or matrimonial matters. Where the potential valuation may itself be significantly affected by factors such as these could serve to promote the prominence of the relevant date when conducting litigation.

The significant, and perhaps somewhat unexpected, exchange rate fluctuations do not only impact on the day-to-day profitability of UK businesses, but also upon some of the claims that are already beginning to materialise. Whilst the underlying claims, and causes of the claims, are unlikely to be anything remotely connected with Brexit or its direct consequences, those consequences could influence the arguments that are run and significantly impact on the Sterling value of any claims.