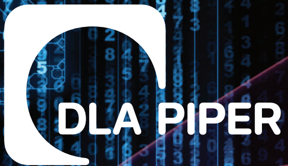

MANUFACTURING MATTERS

February 2016

INTRODUCTION

Welcome to Manufacturing Matters, DLA Piper's specialist publication providing a round-up of legal news, sector updates and commentary for clients and contacts engaged in the manufacturing sector.

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British manufacturers are unfortunately enduring a difficult start to the year, amidst the continuing gloom from the global economy. Concerns about world trade growth and the weakening demand from both developed and emerging markets have become more prominent, with a decline in export orders and a rise in the proportion of companies unable to pinpoint any parts of the world experiencing increased demand conditions.

The gloom may not be universal across all industry sectors, but it seems to be spreading following mounting challenges throughout 2015 – from the collapse in the oil price to weaker than expected construction activity.

Closer to home, the domestic market is also looking less supportive than has been the case in recent years, although some bright spots remain, in particular motor vehicles, aerospace and chemicals.

While the Chancellor's Spending Review will have been seen as supportive to industry, it is critical that the Government continues to act to ensure the UK is a competitive location for manufacturing.

I hope that you enjoy this edition and I wish you a belated, if slightly gloomy, Happy New Year!

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- An interview with Bob Pickles, Head of Corporate and Government Affairs, Canon UK
- Oil price volatility and the risk of corporate contagion
- Asset based lending – another way to raise finance
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- The Volkswagen emission scandal – implications for product compliance

Manufacturing Matters is compiled with current issues and trends in mind. If you would like to get in touch, please contact us by emailing manufacturing@dlapiper.com.

CYBERSECURITY

The average cost of severe online security breaches now starts at £1.46 million – up from £600,000 in 2014, according to government research published in June 2015. Not only is the cost increasing, but also the number of cyber-attacks. John Chambers, CEO of Cisco, recently predicted an exponential rise in both the number of attacks and volume of successful penetrations. Effective cyber defence requires a different approach to traditional compliance models.

Cybersecurity has become a top-tier risk for businesses. The sophistication of cyber weaponry means any hacker, if determined enough, can penetrate organisational security boundaries to access/remove sensitive data. For many businesses, this is likely to have already happened, typically without even being aware given the ability of the hacker to cover their tracks.

Attackers innovate rapidly and work anonymously to place themselves beyond the reach of law enforcement. Arrests are rare and the cyber underworld has its own information sharing network, meaning vulnerabilities once found are rapidly distributed.

Unfortunately investing in defensive measures alone is not the solution. Attacking techniques evolve as quickly as new counter measures arrive, whilst the demand from staff and customers to have multi-channel/24x7 access to resources means an ever increasing number of points of entry to corporate systems. The growth of the Internet of Things provides a further field of potential target, whilst outsourcing and extended supply chains create some of the best opportunities to penetrate systems through third party connections via backdoors built into components.

Even where a hack may pose little risk of actual harm to consumers, the reputational harm of an attack is likely to be significant if it becomes public. There's also the risk of business disruption, loss of competitive advantage (if trade secrets are stolen) and the handling of any regulatory inquiries that may flow from the breach, together with associated forensic analysis and PR/legal costs.

Cyber risk management requires a more agile approach to risk management than other boardroom level risks – a multi-disciplinary approach is needed that looks not only across internal business lines but also works collaboratively with industry peers. The most effective models anticipate an exchange of information about emerging threats within industry sectors, supported by a coherent information governance strategy within the business.

QUESTIONS TO ASK YOURSELF:

- **Do you have a strong governance program in place?**
  The *NACD Cyber-Risk Oversight Handbook*, which DLA Piper lawyers helped to draft, provides a helpful roadmap for demystifying cybersecurity and establishing a structure so directors can meet their duty of care.
- **Do you have an incident response plan in place, and have you tested it?**
  Implementing an incident response plan for cyberincidents and conducting tabletop exercises to gauge how your business would act to an incident is a key countermeasure to reduce the costs flowing from a data breach.
- **Are you conducting periodic cybersecurity risk reviews?**
  Companies often need to conduct outside assessments to meet duties of care and to pass third-party cybersecurity audits required by customers.
- **Are you managing your supply chain risk?**
  Addressing vendor and supply chain risk is an important part of cyber-risk management. One part of this effort involves managing vendor agreements to require, among other things, providing notice of suspected (not just actual) breaches, requiring third-party security audits and obtaining adequate indemnification. A related test for purchasers and suppliers is tracking agreements that need updating when open for renewal and mapping notification obligations in the event of a breach. It can also be important to obtain third-party security audits further down the supply chain of component suppliers.
- **How do you respond to a breach?**
  It is critical to respond quickly and effectively to an incident, conducting a thorough investigation to events on the ground whilst in parallel handling any regulatory notices/messages to customer who may be affected. In the case of a payment card breach, it is important to upload affected card numbers through a merchant's payment card processor so that the numbers are flagged for fraud monitoring to avoid potential card fraud.
- **Does your insurance adequately cover data breach risk?**
  Insurance is a key part of risk management and can offer significant protection for monetary costs incurred from data breaches. Finding the right coverage for your organisation's risk posture is important.
- **Are you addressing cybersecurity risk in M&A transactions?**
  Over the past decade, M&A transactions have resulted in some costly security liabilities. Cybersecurity risk has grown so important that it merits particular attention in the due diligence process. Furthermore, cybersecurity risk must be addressed during post-merger integration. Legacy systems are often vulnerable to attack and it is important, where possible, to implement post-merger security solutions reflecting best practices.
- **Are you keeping up with rapidly changing regulatory requirements?**
  Cybersecurity and data security are topics of great concern to policymakers. Requirements are changing rapidly around the world and enforcement is increasing. While compliance with regulatory requirements is no guarantee against a security incident, suffering a reportable security incident when out of compliance can significantly increase risk, penalties and adverse publicity.

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THE MODERN SLAVERY ACT – TRANSPARENCY IN GLOBAL SUPPLY CHAINS

The UK has enacted ground-breaking legislation, the Modern Slavery Act 2015, which will require large manufacturing companies to be transparent regarding the impacts of their supply chains.

THE OBLIGATIONS

Commercial organisations with an annual turnover of £36 million, which supply goods or services in the UK, will be required to publish an annual slavery and human trafficking statement to report on what actions they have taken to ensure slavery and human trafficking is not taking place in their supply chains, or *any* part of their business. The statement must include "*a statement of the steps the organisation has taken during the financial year to ensure that slavery and human trafficking is not taking place in any of its supply chains*" or that they "*have taken no such steps*".

The statement ***may*** include information about:

- the organisation's structure, business and supply chains;
- its policies in relation to slavery and human trafficking;
- its due diligence processes in relation to slavery and human trafficking in its business and supply chains;
- the parts of its business and supply chains where there is a risk of slavery and human trafficking taking place, and the steps it has taken to assess and manage that risk;
- its effectiveness in ensuring that slavery and human trafficking is not taking place in its business or supply chains, measured against such performance indicators as it considers appropriate; and
- the training on slavery and human trafficking available to its staff.

The statement must be approved by the board, signed by a director, and published on the company's website.

WHEN WILL IT TAKE EFFECT?

The legislation came into force at the end of October 2015. The statement must be published after the end of the organisation's financial year (Government Guidance suggests within six months). There are transitional provisions for companies whose next year end falls between 29 October 2015 and 30 March 2016; these organisations will not be required to publish a statement until the end of the following financial year.

WHY IS IT RELEVANT FOR MANUFACTURERS?

This legislation is particularly applicable to large manufacturing companies. The trend in the sector is towards leaner sourcing models, which can lead to peaks and troughs in labour supply, increasing the risk of exploitation. Verifying supply chains are "slavery free" presents a real challenge for manufacturers, particularly past Tier One where there is decreased visibility. Suppliers in certain jurisdictions pose a particularly high risk, where the use of low paid, temporary or migrant workers is prevalent.

Affected manufacturers have three options:

1) publish an annual statement setting out the steps it has taken during the financial year to ensure slavery and human trafficking is not taking place in any of its supply chains or any part of its business; or
2) publish a statement that it has taken no such steps; or
3) decline to publish a statement.

Only options (1) and (2) will be legally compliant. Manufacturers need to consider now:

- what time, resource and money will be required to comply;
- how feasible is it to identify all supply chains and take steps in relation to each;
- what steps are actually required in practice;
- what is the relationship with suppliers and where does the bargaining power lie;
- what competitors are doing. What is the general approach of the sector/market;
- what are the potential risks to reputation and negative attention from the UK's independent anti-slavery commissioner, shareholders, investors, customers, trade unions and civil society, such as non-governmental organisations and human rights groups; and
- what is the potential for exclusion from tendering for public sector or private sector contracts in relation to businesses who have themselves published a statement of steps and/or require their suppliers to.

PREPARATION

Organisations who engage with the legislation will need to take steps to address each part of the annual statement. These are likely to include:

- mapping of suppliers and identification of high-risk activities/geographies;
- creation of new policies and procedures on slavery and human trafficking;
- review of existing policies and procedures to 'dovetail' with slavery and human trafficking processes;
- implementation of a confidential reporting line;
- proactive risk management, including supplier audits;
- training of employees, suppliers, contractors; and
- identification of key performance indicators allowing progress to be benchmarked and monitored.

In the first year of compliance, an organisation may choose to simply set out its strategy for combating modern slavery risks, rather than taking material and substantive steps. It will, however, be critical for the organisation to continue to build on, and begin implementation, of its strategy year-on-year.

With so much at stake, companies and their directors need specialist advisors to help them navigate this new terrain. With leading labour law, human rights and regulatory and government advisory expertise, along with our global reach and local knowledge of the salient risks pertinent to each jurisdiction, we are ideally placed to support companies during the complete life-cycle of human rights issues.

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INVESTMENT
IN CENTRAL AND EASTERN EUROPE

The rise in labour costs in Asia has forced investors to look for business opportunities in other parts of the world. From 2010 to 2011, wages in Shenzen, one of China's most important manufacturing cities, doubled, and in Shanghai they increased by 60%. Between 2002 and 2010, the hourly rate of remuneration of Chinese workers increased by 231%.

There has also been a significant growth in the level of social welfare levies in rapidly developing Asian countries, making this region less attractive to investors in terms of labour costs. Central and Eastern Europe ("CEE") is a low-cost and developing part of the European Union (the "EU") where manufacturing is a preferred economic focus. In recent years, CEE has become a place for the focus of manufacturing activity.

ADVANTAGES

CEE countries offer many advantages for foreign manufacturing investors. Today, the average labour costs in countries such as Poland, Hungary, Slovakia and the Czech Republic are similar to those in Shenzen. Corporate taxes in these countries are generally low, compared with other European countries, and the legal and regulatory environment has also become increasingly investor-friendly. All CEE countries are constantly striving to reduce administrative burdens on investors and they have also improved their physical infrastructure, leading to more efficient logistics and supply chains.

Moreover, governments in CEE countries offer various grants and incentives to foreign investors establishing manufacturing facilities in the region. They offer grants for the acquisition of assets, job creation and tax incentives. Finance is usually provided to companies planning investments in priority sectors such as automotive, electronics and household appliances, aviation, biotechnology and food processing.

According to Michael Kern, CEO of the Polish-German Chamber of Industry and Commerce, "*German investors in Poland value it most because of its EU membership, its employees' skills, qualifications, commitment and productivity, and for the quality of its academic education.*"

AUTOMOTIVE

Recent trends show the automotive industry in particular sees advantages in setting up manufacturing plants in CEE. The region has become a leading automotive manufacturing centre – with 60% of Germany's automotive production there in 2014. Poland is the number one bus manufacturer in the EU, Hungary has a strong vehicle component manufacturing sector, the Czech Republic specializes in the manufacture of small cars and Slovakia is the world's number one producer of cars per capita.

British carmaker Jaguar Land Rover, owned by Indian Tata Motors, has recently decided to build a new vehicle manufacturing plant in Slovakia, worth £1 billion and with a production capacity of 300,000 cars per year. The awareness of the importance of CEE markets is also clearly visible in General Motors' recent decision to locate its Global Business Services centre in Poland, an operation that will coordinate and support over 20 facilities in Europe. GM Manufacturing already employs a total of 3,900 people in Poland.

OTHER SECTORS

Companies from other sectors have also started locating their manufacturing plants in CEE. ABB, the leading power and automation technology group, is planning to invest $50 million to strengthen its manufacturing facilities in the Czech Republic and $30 million to build a new plant in Poland. BASF recently opened its largest European production plant for mobile emissions catalysts in Poland.

Leading pharmaceutical companies have also begun locating their manufacturing plants in CEE. Servier Group has invested around zł150 million in Poland. In the words of Colm Murphy, Production Site Director of Servier Group, "*in Poland we are delighted to have a highly qualified workforce with relevant experience in the pharmaceutical sector. The availability of the required skillset in designers and contractors and the support from local authorities has contributed enormously to our success.*". Xavier Douellou, Managing Director of 3M Poland, also sees potential in Poland and in the Polish workforce: "*Over the last 20 years, 3 million has invested over $350 million in Poland. Poland's highly-qualified people and stable economic situation attracts companies like 3 million which want to grow here in order to expand internationally*".

CONCLUSION

China still seems to be the workshop of the world. However, low labour costs, a highly-skilled workforce, a good location, a friendly legal and business environment and many other factors are making CEE one of the most attractive regions for investment – something that is unlikely to change in the near future.

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INTERVIEW WITH CANON UK

BOB PICKLES, HEAD OF CORPORATE & GOVERNMENT AFFAIRS CANON UK

LOOKING AHEAD TO THE NEXT THREE YEARS, WHAT ARE THE BIGGEST CHALLENGES YOU SEE MANUFACTURERS FACING?

Manufacturers today are facing more complex business challenges than ever before. In order to stay competitive in a global marketplace, they are under increasing pressure to produce higher quality goods at faster response times and lower costs. Mass customisation is adding to the weight of these considerations, and in order to balance customer expectations with sustainable growth and productivity, manufacturing must capitalise on recent technology advancements and the benefits digital transformation can bring.

Manufacturing productivity has increased by over 5% in the past year compared with only 0.3% within the entire UK economy. With focus firmly on the continuation of this growth and prosperity, the industry must decide how it approaches productivity and the value of the processes powering it. The question for modern British manufacturers is how to ensure business investment powers future growth and avoids stagnation. After all, a strong UK economy needs a strong UK manufacturing sector. British manufacturing can – and should – continue to build on its success and whether its streamlining processes or improving the layout of factories, there are plenty of ways for manufacturing to become leaner and more efficient.

BEARING THESE CHALLENGES IN MIND, HOW DO YOU THINK THE GOVERNMENT CAN BETTER SUPPORT UK MANUFACTURERS?

Both the public and private sectors need to work together to overcome these challenges and support one another as we face a decline in the manufacturing supplier base. The Government is already looking to increase its support of the manufacturing sector with a new fund, launched in 2015, to provide further support to an industry which contributes almost £150 billion a year to the UK.

WHERE DO YOU SEE THE OPPORTUNITIES IN THE MANUFACTURING SECTOR IN THE UK AND INTERNATIONALLY IN THE NEXT 12-18 MONTHS?

3D printing is a perfect example of how technology can be used to take the already innovative manufacturing sector to the next level. Today's consumers demand customised products and services with immediacy – which isn't always economical with traditional manufacturing processes that are optimised for large volumes of consistent output in industrial centres. But 3D printers can – and increasingly are – being used to economically create customised, improved and sometimes even difficult-to-manufacture products right where they will be used. It is quite literally a factory without the need for a factory, as a single printer can produce a vast range of products, sometimes already assembled.

Canon is currently making its first steps with 3D Systems into this promising market. At our recent EXPO event in Paris, we showcased two 3D Systems printers, demonstrating how we envision manufacturing to become more efficient, productive and collaborative. In addition to 3D printers, we recently launched the Canon 3D Machine Vision Systems, for use with industrial robots and capable of high-speed, high-accuracy three dimensional recognition of objects. The new systems are designed to increase production efficiencies in factories by facilitating the automatic high-speed supply of parts to production lines.

However, with new technologies changing the face of modern manufacturing, manufacturers will need to recruit and train the right people to help move the industry forward in-line with technological innovation. Remaining productive will be more important than ever.

WHICH SECTORS WITHIN MANUFACTURING DO YOU THINK WILL BE ABLE TO SEIZE THESE OPPORTUNITIES AND EXPLOIT THEM FOR POSITIVE GROWTH?

For a long time 3D printing was something only larger enterprises could afford due to the high investment costs. Technological developments of recent years have decreased costs for lower-end 3D printers, making the concept accessible to a large audience. This means 3D printing is not only used by a wider range of sectors – such as automotive or domestic appliances – but also by a wider range of businesses, from small to large, which now benefit from the ability to create on-demand specialist tools and more rapid product development. Any initial investment in 3D printing technology could quickly pay for itself.

FINALLY, SUM UP UK MANUFACTURING IN JUST FIVE WORDS

Innovative, rapid, competitive, collaborative and digital.

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OIL PRICE VOLATILITY AND THE RISK OF CORPORATE FAILURE CONTAGION

Depressed prices in a number of global commodities has taken a significant toll on UK manufacturers. Business news has been dominated by the steel industry crisis and a similarly negative story faces UK companies connected to the oil and gas industry. The dramatic decrease in the price of crude oil since summer 2014 has had global ramifications.

The price decline is attributable to various factors. There is, (as with steel) over supply. The addition of new production from unconventional sources such as US fracking, coupled with the apparent strategy of the Organisation of Petroleum Exporting Countries ("OPEC") to maintain production levels, to defend and counteract this growing competition stateside, has served to drive down the average base rate of crude oil. The slowdown in China's infrastructure expenditure, an easing in domestic demand and the drawn out economic recovery in the EU has also had its effect. A stronger pound is impacting on competitiveness leading to weaker export demand.

Against this backdrop, manufacturing businesses operating in, or connected to, the oil and gas sector should prepare for an increase in the distress anticipated as we move into 2016 and existing hedging positions begin to run off further up the chain. With cash flows depleted upstream, many oil companies (particularly smaller independent ones operating in the North Sea who do not benefit from the significant reserves enjoyed by the major international/national oil companies) may face difficulties funding operations, servicing debt, fulfilling contractual obligations and funding new projects.

These problems will inevitably get passed down the chain and companies connected, either directly or indirectly, should consider how they can best protect themselves from the anticipated contagion.

RECOMMENDED ACTION/CONSIDERATIONS

Contracts should be considered in light of the businesses own financial position, the possible distress of the counterparty and the risk of delay, breach and termination. Examination will be against a potentially altered financial dynamic to that in place when the contract was first entered into.

It is important that directors understand and identify both the risks and opportunities that will present themselves.

CUSTOMER AND SUPPLY SIDE RESILIENCE

Companies should monitor events as they occur, focusing particularly on the financial viability of contractual counterparts (customers, suppliers or sub-contractors). This will allow them proactively – and preferably pre-emptively – to address problems and, in some instances, improve bargaining positions.

Ensuring contractual rights are as robust as possible will be key. Are there retention of title or other contractual or security protections available in the event of the insolvency of the counterparty?

Can you negotiate rights of access or information likely to signal an early warning of counterparty insolvency to put you ahead of competing creditors? Where there is risk of delayed performance or, worse, complete failure to perform, the implications need to be understood.

CONTRACTUAL REVIEW

Where a contractual default appears likely, planning in advance to manage the potential consequences of default is imperative. Focus will be on mitigation: particular contracts entered into pre-oil price collapse may no be longer be profitable and corporates are looking to extricate themselves. A full understanding of contractual rights and obligations is important to assess termination rights and, where termination rights are not available, to understand the consequences of breach. Once understood, it may then be possible to terminate or negotiate a more advantageous outcome. Particular attention should be paid to contract formalities (e.g. time limits and notice requirements).

FINANCIAL REVIEW

The expiry of favourable hedge arrangements, constrained cash flows and depressed asset values increase the chance of covenant breaches. The rights and likely attitude of lenders in such circumstances should be understood.

Early engagement with financial backers and other stakeholders will increase the chances of a successful resetting of covenants or other form of restructuring.

HUMAN RESOURCES

A reduction in staffing levels has been a well-publicised feature of the downturn already. To the extent redundancy programmes are being considered, it is crucial the employment laws of the jurisdiction concerned are fully understood and complied with.

The aim should be to minimise financial liability and legal action consuming management time and damaging further employee and public relations.

SAFETY, HEALTH AND ENVIRONMENTAL ISSUES

Safety, health and the environment are vital topics particularly for those operating in the oil and gas sector. Non-compliance with regulatory requirements and failure to address potential liabilities both carry increasing financial risks. Ability to demonstrate good environmental and safety management is not only important for business reputation, but is often a key condition of obtaining both public and private contracts.

DIRECTORS' DUTIES

Directors of distressed companies should consider their own legal duties. Insolvencies in the sector are increasing and directors of companies in a precarious financial state should consider their own personal position in continuing trading.

CROSS-JURISDICTIONAL ISSUES

Consideration should be given to the country whose laws will apply and which courts are likely to have jurisdiction.

Whilst possibilities may present in the form of opportunistic pricing, given the over-supply in the upstream market, as well as favourable contractual renegotiation with counterparties who find themselves in a weaker bargaining position, the key to survival is preparation for those challenges which will or may present as a combination of these factors conspire together to create an increasingly difficult and uncertain market for UK manufacturers. There can be no substitute for a thorough review of the business' corporate hygiene to ensure it is best placed to weather the contagion that some commentators are predicting.

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ASSET BASED LENDING
ANOTHER WAY TO RAISE FINANCE

If manufacturers are thinking of using ABL as a way to raise finance, or they are about to re-finance or re-negotiate an existing ABL facility, what should they be focusing on when the term sheet or offer letter from the bank lands in their inbox?

WHAT IS ABL?

Most lending decisions will take into account (to a greater or lesser degree) the value of the manufacturer's assets, but Asset Based Lending ("ABL") focuses on generating funds from four key asset classes, which can be combined to produce a "borrowing base":

- Invoices/debts
- Stock/inventory
- Plant & machinery ("P&M")
- Real estate

By applying a formula or advance rate to the relevant assets (e.g. 75% of the liquidation value of the stock) the funder can provide a revolving working capital facility.

Not all of these asset classes are relevant for every business, or will necessarily be attractive to a funder, but ABL facilities generally combine invoice finance – as the core product – with at least one other asset class.

Eligibility – Not all assets are funded. Typically an ABL facility agreement will identify classes of eligible assets, and various exceptions. Most of the exceptions are well-understood but some may inadvertently take a portion of your assets outside of the calculation if they are not tailored. Funders will also typically require the discretion to designate other classes of asset as ineligible in the future – this could reduce your available funding and would go to the question of commitment.

Covenants – There will likely be asset-specific covenants, such as "debt turn" (how long on average it takes debtors to pay invoices) or ratios of the value of the assets to the amount of outstanding funding. The key with the asset covenants is firstly to ensure they are properly tailored to your business and secondly to understand the effect of breaching them – ideally, the consequence should be an objectively determined reduction in availability, rather than a termination of the whole facility. ABL funders will often also ask for similar whole-business financial covenants to the traditional bank funders e.g. measuring EBITDA, and will try to resist arguments that they don't need these covenants because they are protected by the assets.

One of the advantages of ABL for manufacturers can be that there is often a lower cost of capital for the funder, meaning cheaper pricing than comparable working capital facilities.

Financial reporting – There is no question that ABL facilities carry a greater administrative burden in terms of reporting than traditional term debt or RCF structures. The ABL product only works if comprehensive asset information is provided on at least a weekly basis. You need to ensure that your accounts team understands this, knows what is required, and can deliver 'clean' information on-time. But you might also be able to tailor what needs to be provided based upon your projected usage of the facility.

Documentation – There is usually a choice: use the funder's standard form documents for speed and lower legal costs, but accept that these documents are not negotiable and usually unreasonable, or switch to longer-form documents and negotiate in full. Note that there is no Loan Market Association template for ABL transactions, so it can be more difficult to be confident that you have market standard terms without taking specialist advice.

Commitment – This is the biggest issue of all. Is the facility which you are being offered "committed", i.e. once you satisfy any conditions stipulated in the agreement, is the funder then obliged to advance the funding whenever you request it? This is not a straightforward question in ABL facilities (contrast an RCF) where funders will try to retain certain discretions which might reduce the amount which you are able to borrow. For the funder, this is partly a question of managing their credit exposure (they are effectively agreeing on day one to fund assets which do not then exist) but also a question of pricing: committed facilities carry a greater cost of capital than uncommitted facilities.

In the early years of the invoice discounting/factoring industry in the UK, ABL gained something of a reputation for being used as funding of "last resort". There were too many deals done with an expectation that the business would fail and the goal was to make money on the recovery/exit fees, but that's old news. ABL is now a sophisticated, large-ticket product which is competing with other debt packages for both domestic and cross-border deals.

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EU-CANADA
ECONOMIC TRADE AGREEMENT WHAT YOU NEED TO KNOW

WHAT IS CETA?

The Comprehensive Economic and Trade Agreement ("**CETA**") is a trade and investment agreement that has been negotiated between the European Union (the "**EU**") and Canada. CETA aims to improve trade and investment between the EU and Canada through the removal of customs duties, ending limitations in access to public contracts, opening up services' market, offering more predictable conditions for investors and also preventing the illegal copying of EU innovations and traditional products. UK Trade and Investment have estimated that CETA will boost the UK economy by £1.3 billion per year.

BENEFITS FOR UK MANUFACTURERS

Cutting the cost of exporting and importing goods between the EU and Canada CETA will eliminate all industrial duties – estimated to save European exporters around €470 million a year. Most industrial customs duties will be removed when CETA enters into force and some will be gradually eliminated, with the phase outs ranging from three to seven years, depending on the particular product. For instance, Canadian customs duties payable on the import of a number of EU origin aeronautic equipment, plastic products, rail related parts and equipment, marine engines and fabrication materials are going to be removed immediately. Duties payable on the import of certain EU origin automotives and vehicles will be phased out over an eight year period.

Protecting EU innovation. CETA will create more level playing field between Canada and the EU as regards to intellectual property rights, with European innovations and brands being better protected against being unlawfully copied.

Promoting and protecting investment in Canada. CETA removes and alleviates barriers for investors to enter the Canadian market. Moreover, the agreement ensures all European investors in Canada are treated equally and fairly.

Increasing access to public contracts. CETA will allow EU companies to bid for public contracts in Canada on a federal, provincial and local level. CETA includes provisions which ensure EU and US companies are not discriminated against in the bidding process and, therefore, places EU companies on an equal footing with Canadian companies. European businesses will be the first foreign companies to get this level of access to Canadian public procurement markets as no other international agreement concluded by Canada offers similar opportunities.

Increasing regulatory co-operation. CETA contains provisions that will improve transparency and form closer contacts in the field of technical regulation between the EU and Canada. For instance, the EU and Canada have agreed to enhance cooperation and communication in the area of motor vehicle technical regulations / related standards, which will make moving vehicles between Canada and the UK easier.

Increasing trade in services. CETA is providing new opportunities for EU service providers and will increase opportunities for temporary movement of employees between the EU and Canada.

Tightening up the existing 'investment-to-state arbitration' provisions. Such provisions allow foreign investors to bring proceedings directly against a state via a separate arbitral process, rather than using the domestic legal system. The rationale is that such a mechanism provides investors with greater certainty that claims will be heard in an impartial manner with increased prospects for enforcement.

WHEN WILL CETA ENTER INTO FORCE?

The CETA negotiations concluded in August 2014. However, CETA must be approved by the European Parliament and the governments of the EU Member States before it can come into force. It is estimated that CETA could be applied from the beginning of 2017, provided that the Council, European Parliament and the Canadian legislature approve the agreement in 2016 as expected.

CONCLUSION

The entry into force of CETA will open up a number of new opportunities for UK manufacturing companies in Canada, placing UK companies on at least a level, if not advantageous, playing field compared to competitors in other third countries e.g. the US.

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BREXIT
THE IMPLICATIONS FOR UK MANUFACTURERS

The possibility of a UK exit from the EU (colloquially known as a Brexit) is high on the political, business and media agenda. What are the key questions for the manufacturing industry?

TRADE

The EU is currently Britain's biggest trade partner. More than 50% of the UK's exports go to the EU. Four of Britain's six biggest export partners are EU Member States, the other two being the US and China. The EU is also Britain's closest trade partner, and empirically (according to analysis by CityUK) trade declines with distance.

- If the UK left the EU, on what terms would it be able to access EU markets? Various alternatives have been proposed, but would any of them be as favourable as the current customs union?
- Without the EU behind it, how would Britain fare at the negotiating table when doing trade deals with non-EU countries? The EU currently has 23% of world GDP – the UK only 3.5%. The US has said it is not interested in a UK-US free trade agreement.
- That said, EU trade agreements are slow to negotiate and often the product of compromise – shouldn't Britain, a leader on the global stage, be able to do better alone?
- If a Brexit caused a reduction in trade, what might be the broader effect? A reduction in trade has been linked to reductions in productivity and innovation on the basis that, as market size and competition shrink, productivity may do the same (again, CityUK has done the analysis).
- Would restrictions to free movement of people from and to other Member States have a positive or negative impact?

RED TAPE

Manufacturing is highly regulated, and most of this regulation emanates from Brussels. Perhaps, the argument goes, a post-EU UK would be less constrained by red tape.

- Will regulation lessen in the event of a Brexit? Or are regulators and regulation now a fact of life for business across the globe, with the UK no exception?
- If the UK wants to do business with the EU following a Brexit, won't it have to comply with EU regulations in order to do so, but in circumstances where it can no longer negotiate, influence or challenge those regulations?

FOREIGN DIRECT INVESTMENT (FDI)

According to EY's Attractiveness Survey, the UK attracted more FDI projects than any other European country in 2014. Many investors regard the UK's access to the EU an important part of its appeal.

- Will FDI reduce in the run-up to the referendum as investors become cautious?
- Will international companies based in the UK (or even some domestic companies) relocate elsewhere in the EU in the event of a Brexit? Some foreign investors – such as Siemens – have already signalled the importance to their business of Britain's EU membership.
- Or will Britain still have plenty to offer investors in terms of timezone, language, skills, legal system and culture? Wouldn't market forces continue to operate?

LEGAL FRAMEWORK

The UK's legal system has become tightly enmeshed with that of the EU over a period of 40 years. The unravelling process would be long, complex and no doubt expensive.

- Which European legislation and regulation does the UK like or need and therefore want to keep? Regulations on jurisdiction, governing law, service of legal proceedings and enforcement, for example, are all designed to achieve certainty, consistency and efficiency in cross-jurisdictional contracts. The UK might not want to give these up.
- If European legislation is stripped out of the UK system, where are the gaps?
- Is there a risk that, over time, new UK legislation becomes incompatible with EU legislation and the systems drift apart?

There will also be an inevitable period of uncertainty in relation to existing contracts. For example:

- Will a contractual requirement to comply with a particular piece of EU legislation still be binding following a Brexit?
- Would any principles of EU law continue to influence English courts?
- In the event of a Brexit, will some counterparties try to terminate their contracts, for example by citing force majeure or material adverse change? Will some contracting parties want to specify Brexit expressly in their contracts as being a termination event?
- How would a judgment from the English courts be enforced in the EU?
- In light of the uncertainty, will some parties move away from choosing English law and jurisdiction to govern their contracts?

COMMENT

The Brexit debate is full of questions, as this brief analysis shows. Will the UK be more prosperous or poorer following a Brexit? How far will GDP fall, if at all? Will the UK become more regulated or less? What will happen to Scotland if the UK votes to leave the EU? It may be that the outcome of the referendum is decided (as the Scottish referendum is said to have been) on the basis of just this uncertainty, with voters choosing the status quo over fear of the unknown. What is clear is that there is still everything to play for, on both sides of the Brexit debate.

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THE VOLKSWAGEN EMISSION SCANDAL – IMPLICATIONS FOR PRODUCT COMPLIANCE

COMPLIANCE

The crisis surrounding the Volkswagen ("VW") emissions scandal provides timely warnings for manufacturers on the importance of product compliance, creating a strong message that any company in a similar situation should completely avoid it, or get out of it as soon as possible. As clearly highlighted below, failure to do so could result in huge, sometimes catastrophic, costs and brand/reputational damage.

If a manufacturer is found to be in breach, regulators may face questions regarding their prior knowledge of the position – the VW scandal highlights that any connivance on their part will not provide an excuse when things go wrong.

THE SCANDAL

The scandal relates to "defeat devices". The cars' software used an algorithm that incorporated information about steering patterns, engine use and atmospheric pressure, to allow it to recognise when the car was being tested and to switch emissions controls on and off accordingly. This would cheat the tests in a laboratory setting, but when on the road with emissions controls switched off, cars would pump out nitrogen oxides (NOx) at up to 40 times the legal limit.

VW's admission that approximately 11 million cars worldwide, including 1.2 million in the UK, across VW, Audi, SEAT and Skoda models are affected, has led them to set aside some £4.8 billion to cover the costs of recalling these cars. However, with further evidence emerging in Europe that VW has experienced "irregularities" in tests to measure carbon dioxide emissions levels that could impact a further 800,000 cars, including some fuelled by petrol, it remains to be seen whether this provision will be anywhere near sufficient.

MOUNTING COSTS

Beyond the £4.8 billion, VW is set to suffer substantial regulatory penalties and civil damages. It is already facing criminal investigations in several jurisdictions with up to $18 billion (£12 billion) in penalties under the US Clean Air Act. In the EU "defeat devices" are expressly prohibited by Article 5 of the Emissions Regulation No 715/2007. This requires member states to provide for penalties where manufacturers use defeat devices, but the precise details of the sanctions may differ depending on the implementing legislation.

Alongside the criminal penalties, is potential for civil claims by consumers depending on the laws of each jurisdiction. In England and Wales, it may be argued that by advertising certain information on fuel consumption or emissions, a manufacturer could be giving the end consumer a warranty, in consideration of the consumer entering into a contract with a retailer, thus creating a direct contractual relationship for a claim against the manufacturer.

In order to receive civil compensation, consumers must prove they have suffered loss as a result of VW's breach. In this context, there are two potential areas of loss to be claimed against:

1. The resale value of VW cars has taken a hit since the scandal emerged. While this may recover with time, affected consumers will, as matters stand, be entitled to claim the difference between the actual resale value of their cars and the value they could achieve were the cars to perform at the levels promised. With over 11 million cars involved, even a small fall in value for each of those vehicles could result in a huge total liability.
2. A second clear area of loss is the difference between the rates of car tax that consumers believed they would have to pay when purchasing the car and the level they will actually be made to pay.

To mitigate this particular loss, in the UK the Government has announced motorists will not be forced to pay more in car tax even if their vehicles are found to be fitted with illegal software. However, not all countries will be taking such an understanding approach; in other jurisdictions this may leave VW open to claims to make up any differences in tax that consumers are made to pay.

Product recalls and VW's complicated manufacturing and supply chains may lead to many claims from suppliers too.

A SILVER LINING?

One positive aspect that may emerge is the software used by VW to cheat the emissions tests could be used for legitimate purposes. This may even provide some partial explanation for VW's conduct.

For example, NOx emissions, which are poisonous and associated with causing respiratory problems in humans who suffer higher than normal exposure, could be reduced in inner city areas in favour of emitting higher levels of CO_2 or an increase in fuel consumption. In contrast, in less densely populated countryside areas, where NOx emissions are of lesser concern, emissions or fuel consumption could be reduced in favour of higher NOx emissions.

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