MACFARLANES

EURO TURMOIL ISSUES

BANKING AND FINANCE

There is considerable commentary in the press about the prospects of one or more countries, with a particular emphasis on Greece, leaving or being expelled from the Eurozone. This note highlights some of the key issues surrounding a potential break-up of the Eurozone and how it might impact on legal obligations.

POSSIBLE SCENARIOS

In contemplating a fracturing of the Eurozone, the following general scenarios might be envisaged:

1. one or more "struggling" member states (each a "**Departing State**") unilaterally leaves the Eurozone to try to forestall further economic collapse – a "**Unilateral Withdrawal**";

2. one or more "struggling" Departing States negotiates a withdrawal from the Eurozone with the blessings of the relevant EU bodies – a "**Negotiated Withdrawal**";

3. one or more "robust" Departing States unilaterally leaves the Eurozone in protest at supporting weaker peers – a "**Unilateral Resignation**";

4. one or more "robust" Departing States negotiates a withdrawal from the Eurozone with the blessings of the relevant EU bodies – a "**Negotiated Resignation**";

5. one or more "struggling" member states is expelled from the Eurozone – an "**Expulsion**"; or

6. the Single European Currency is abandoned by all – a "**Disintegration**".

ANALYSIS OF SCENARIOS - DEPARTURE MECHANICS

The first legal issue encountered in analysing any of these scenarios, is that the various EU treaties (the **"Treaties"**) do not contemplate withdrawal from the Eurozone without withdrawal from the EU as a whole. While Article 50 of the Treaty of the European Union (**TEU**) does allow withdrawal from the EU, there is (a) no separate right to merely leave the Eurozone and (b) in any event, no set process or mechanics to effect such a withdrawal.

On that basis, any consensual departure (a Negotiated Withdrawal, a Negotiated Resignation or Disintegration) will require additional legislation and amendments to the Treaties and the approval of all 27 member states. Such legislation would also need to settle questions of continuity of contracts and monetary issues surrounding the new national currency (**NNC**) of each Departing State.

Given this requirement, a lawful, consensual departure from the Eurozone will be extremely time-consuming, and by no means guaranteed. A quick departure is therefore practically not viable for any state, with two possible, but unlikely, exceptions:

A. a sub-national part of a member state, for example, Flanders may be able to leave the Eurozone if it secedes from the relevant state but chooses an alternative NNC. Some commentators believe such an entity may be able to remain in the EU with fewer legislative headaches than a full Negotiated Withdrawal or Resignation would incur. However, there would still be many questions to answer; or

B. a Departing State could resign from the EU under Article 50 TEU and then apply to rejoin. That would comply with the legal formalities of the Treaties; however, the economic collapse unleashed by such a departure may make it unlikely that the remaining members of the EU would welcome the Departing State back. Furthermore, technically under the Treaties, the rejoining state would be obliged to sign-up to the Euro as soon as the economic tests set out in the TEU were fulfilled (unless an opt-out were negotiated), thus rendering this method of departure less useful.

In this regard it should be noted that an Expulsion would face the same issues. There is no expulsion process in the Treaties, and so any attempt to remove an unwelcome member would require its full co-operation and involvement in the legislative process. This makes Expulsion an unlikely scenario.

Finally, Disintegration could occur as either the deliberate process of the Member States as a whole, in a decision by each of them to call it a day or as a result of a failed attempt at a Negotiated Withdrawal or Resignation. Given the political fallout that this would entail though, it would seem highly unlikely.

On that basis, the most probable scenario is an unlawful Unilateral Withdrawal or Unilateral Resignation by a Departing State in breach of the Treaties.

CONSEQUENCES – GENERAL FINANCIAL ISSUES

As may be expected, the consequences of even a Unilateral Withdrawal by a single Departing State are severe:

On a macro level:

- fear of contagion spreading to other peripheral Departing States;
- further curtailing of the capital markets and investor appetite in general;
- increased liquidity problems, difficulties refinancing and bank recapitalisation;
- flight to quality or safety, bank runs, general decrease in deposits in Eurozone banks; and
- political recriminations, increased hostility to European institutions and possible civil unrest.

On a micro level:

- failure of treasury or banking systems and processes;
- sudden increased exposure under FX contracts;
- withdrawal of credit lines;
- imposition of capital controls; and
- legal uncertainty.

As regards the particular Departing State the following issues may be relevant:

- new legislation will be needed to impose an NNC and set an exchange rate;
- a dramatic depreciation of the NNC against the Euro is likely to occur (most commentators assume 40-60 per cent), harming savings and people's ability to repay international debts or, if it has been a Unilateral Resignation, a dramatic appreciation of the NNC, harming exports;
- redenomination of bank accounts into the NNC will need to be settled, with questions as to how far this should go – accounts of foreigners? USD or GBP accounts?
- electronic and physical capital controls will almost certainly be imposed to prevent capital out-flows;
- the trade tariffs are likely to be imposed by the remaining member states to protect against the reacquired export strength of the Departing State's enterprises; and
- all existing trade agreements entered into with and through the EU will be terminated.

In general therefore, the costs of any such scenarios will be high. In September 2011, economists from UBS estimated[1] that in a Unilateral Withdrawal of, say, Greece, the cost per person to the Departing State would be between €9,500 to €11,500 in the first year, and €3,000 to €4,000 in each subsequent year. Even for the Unilateral Resignation of, say, Germany, the costs per person to the Departing State would be between €6,000 and €8,000 in the first year and €3,500 to €4,500 in each subsequent year.

This contrasts with an estimate of the cost to each person in Germany if Greece, Ireland and Portugal defaulted on all of their debt with a 50 per cent haircut of €1,000 per annum.

That having been said, there are some precedents to states leaving monetary unions and then thriving: the UK after Black Wednesday and Argentina after abandoning the peso's dollar peg in 2002, both saw their economies gradually come out of recession. However, many other factors were at play for each such scenario and similar consequences for Departing States cannot be guaranteed.

CONSEQUENCES – CONTINUATION OF FINANCIAL CONTRACTS

If one of the scenarios described above were to occur, one issue is to what extent existing contracts would survive a departure or break-up. From the perspective of English law contracts, and in the absence of any specifically negotiated provisions covering a state leaving the Eurozone or the EU, the risks of any automatic termination are actually fairly low.

This is because a change in currency is highly unlikely to constitute a common mistake. Equally the requirement in the test for frustration that performance under the contract in question has become unlawful or impossible or radically different from that originally contemplated by the parties[2], means that the simple replacement of one currency by another is unlikely to frustrate the contract – the parties still remain liable to perform the key obligations under the contract. One exception to this is if there had been a Disintegration and the Euro had ceased to exist as this may go to the root of the contract (particularly for a FX contract) leading to a finding of frustration. It is more probable however that courts would determine that this result was commercially unsatisfactory and would therefore imply terms to settle in other currencies.

The principal risk is therefore a widely drafted force majeure clause. This will have to be checked on a case by case basis.

[1] "Euro break-up – the consequences", Deo, Donovan, Hatheway (UBS Investment Research - Global Economic Perspectives, London, 2011)

[2] Davis Contractors Limited v Fareham UDC [1956] AC 696

There is however an indirect risk of termination, particularly in financial contracts. This arises from:

A. an entity finding it difficult or impossible to repay in the currency that the obligation was denominated in, due to the entity's assets being redenominated into the NNC. This may lead to payment defaults when the relevant payment becomes due; and/or

B. a material adverse change clause being triggered by a counterparty being concerned that as a result of the particular departure, the relevant entity will not be able to perform its obligations.

As such, everyone with cross-border contractual relationships with entities in the Eurozone considered "at risk" should start to consider whether any of the above will apply.

CONSEQUENCE - PAYMENT OBLIGATIONS AND REDENOMINATION

Assuming a financial contract survives a departure or break-up the next concern in the case of a Euro denominated contract, is to ascertain whether payment obligations under it will remain in Euro or be converted into the NNC at a rate set by the Departing State.

The starting point is the contract itself – does it contain any pre-agreed mechanisms for dealing with the situation the parties are in? In general, few contracts do deal with a potential break-up of the Eurozone. Some contracts, particularly loan agreements, have currency indemnities which are used to cover currency losses of a lender if a judgment against a borrower is given in another currency. This may be relevant if a judgment is obtained by the lender in a Departing State in the NNC, but practically speaking it may not assist the lender in actually receiving Euro, as these may be hard to come by in the Departing State.

In the absence of any contractual remedy, the *lex monetae* needs to be determined. This is an internationally-recognised principle that each state exercises sovereign power over its own currency and chooses what that currency is to be. In the absence of any other factors therefore, if a Departing State were to legislate that all Euro were to be converted into the NNC, then that is the Departing State's prerogative to do so.

On that basis, any payment obligation in the Departing State under a contract governed by the law of that Departing State and between inhabitants of that Departing State will almost certainly be redenominated.

At the other extreme, any payment obligation outside the Departing State under a foreign law contract and between two inhabitants of another state is unlikely to be affected by *lex monetae* of the Departing State.

The more complicated analysis is therefore where there is a mix of laws and jurisdictions giving rise to more than one *lex monetae* applying. On any claim for payment, the courts would have to determine which *lex monetae* the parties intended. This could result in a range of outcomes, and therefore the key point is that each contract will need to be looked at on a case by case basis.

In the absence of any express wording declaring the intention of the parties (such as the currency of account language in an LMA loan agreement), this determination will be based on several key factors to infer the intention of the parties:

1. Place of payment

- In the absence of other persuasive factors, the general presumption is that the law of the place of payment will be the *lex monetae* of the contract[3].
- The place of payment is then generally determined to be taken from the creditor's perspective, so, for example, the bank account where the creditor expects to receive repayment.
- Therefore for international Euro denominated loan facilities, bonds and derivatives, arranged out of London, Frankfurt or Zurich, with a place of payment in one of those places, the *lex monetae* of the Departing State may well be overlooked in favour of the Euro (notwithstanding of course that the *lex monetae* of London is sterling, rather than Euro. However, this should be sufficient to disapply any presumption of the *lex monetae* of the Departing State applying).

2. Jurisdiction

- If the jurisdiction in which the claim is heard is that of the Departing State, then it is likely to have to implement the local redenomination law, unless the parties can show a clear intention to have an alternative *lex monetae* apply.
- In addition, if the Departing State remains in the EU, then other member states bound by the Brussels Regulation will continue to be obliged to recognise and enforce a Departing State's judgment unless manifestly contrary to public policy, potentially redenominating a contract into the NNC.

[3] Adelaide Electrical Supply Co v The Prudential Assurance Co Ltd [1934] AC122 (HL)

- On the other hand, it would be open for courts in other jurisdictions to determine an alternative *lex monetae* based on the parties' intentions and ignore the redenomination legislation, leaving the repayment in Euro, particularly if the place of payment analysis does not favour the Departing State.
- Finally, if the departure had been a Unilateral Resignation or Withdrawal, a court in another EU state would be likely to determine that they could not infer a Departing State's *lex monetae* to apply as it would be manifestly contrary to any public policy to give effect to a new law made in disregard of the Departing State's obligations under the Treaties.

3. Governing law

- If the governing law of the contract is not that of the Departing State in question, this might be further evidence of the parties' intention not to use its *lex monetae*.
- If the governing law of the contract was that of the Departing State, but the forum for the hearing was another state, then the courts are likely to apply the Departing State's redenomination law, particularly if obliged to do so under the Rome Regulation, unless manifestly incompatible with local public policy. This of course leads to the same issue as with jurisdiction, in that courts may well find such a law to be manifestly incompatible.

As can be seen from the above, the analysis of any given contract and factual situation can be complicated. However, we can make certain generalisations for cross-border financings.

For example, if an entity from a Departing State contracts with another entity in Euro where the governing law is, for example, English, the jurisdiction is England and the place of payment is London, the English courts are more likely than not to infer that the *lex monetae* is not that of the Departing State and therefore the Redenomination law does not apply, leaving repayment in Euro.

This can be applied to most international financings that we are likely to see, and most commentators expect the majority of English law contracts would be interpreted so as to continue to require repayments in Euro notwithstanding the exit from the Eurozone.

If though both parties are in a Departing State, and perhaps one or more of the lenders is in the Departing State then the intention of the parties becomes harder to find again. As ever, it will depend on the facts at hand.

There is also a possibility that a court could find there are multiple currencies of payment under a particular contract (which may well be the case in, for example, a hedging contract) but the courts would most likely shy away from any result that is too difficult commercially.

Finally, it should also be noted that even if you have a successful judgment upholding a Euro payment obligation, your ability to extract Euro from your counterparty is likely to be difficult. Not only will local enforcement be legally difficult – in that you will run into the redenomination law if you apply for your judgment to be enforced – but also the counterparty may be unable to or prohibited from, paying you in Euro.

CONSEQUENCES – DRAFTING NEW CONTRACTS

Having noted the above, the principal issues in putting in place new contracts are therefore:

1. ensuring that none of the departure scenarios will trigger automatic termination – so reviewing force majeure and similar clauses;

2. drafting the contract in such a way so as to ensure that the *lex monetae* to be used is not that of any relevant Departing State – ensuring the jurisdiction, governing law and place of payment are for instance, England and waiving any obligation under local law to redenominate;

3. where possible, agreeing up front to insert wording stating that parties' intention is to always repay in Euro, or, in the event of a Disintegration, another strong currency such as Dollars, Sterling or Swiss Francs; and

4. potentially adding mechanisms to deal with currency disputes or disruptions caused by a departure or Disintegration on a negotiated basis.

As a related issue, due diligence for acquisitions, new lending or other new transactions should also generally consider the points above and even if the contract does not lead to currency exposure, whether the parties themselves have sufficient exposure to the Eurozone to make their financial prospects look gloomier.

SUMMARY

Given the wide range of possible scenarios, accurate forecasting and precise advice is difficult.

Contracts are unlikely to be terminated directly as a result of a change in currency. However, the resulting financial consequence may lead to subsequent defaults.

Repayment obligations will depend on the particular contract, but on balance, an English law contract, under the jurisdiction of the English courts, in respect of a cross-border financing is unlikely to result in payment obligations being redenominated.

Finally, any drafting that will direct any such analysis away from any potential Departing States will also be helpful.

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