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Eurozone Crisis: Will Europe Win the Battle? – Practical Advice to Address Your Redenomination Risks

An eventful week in Europe last week, which began with a joint call by German Chancellor Angela Merkel and French President Nicholas Sarkozy for a "forced march towards re-establishing confidence in the Eurozone", has seen the emergence of a new fiscal union in Europe. At the end of the EU Summit on 9 December Eurozone members emerged with promises of moving towards greater fiscal convergence under a new multilateral agreement.

Whilst it is still unlikely that the Eurozone crisis will trigger immediate withdrawals from (or indeed a break-up of) the common currency, both markets and politicians are coming to terms with the very real possibility that a change in Eurozone membership, at this time or at some time in the near future, is no longer out of the question. It is timely, therefore, for banks and other financial institutions and corporates to focus on their financial and legal redenomination risks. This paper sets out a number of practical steps that will assist you in responding to the changing Eurozone landscape.

What to take away from the EU Summit

Eurozone members moved towards agreeing a new multilateral agreement aimed at greater fiscal convergence and all non-Eurozone members of the EU (with the exception of the United Kingdom) have confirmed that they will be putting the new agreement before their national parliaments.

The new agreement – the final provisions of which are to be agreed by March 2012 – will include a requirement for Eurozone member budgets to be balanced, with an annual structural deficit not exceeding 0.5 per cent of nominal GDP. This fiscal rule will need to be introduced into Eurozone members' own national legal systems at constitutional or equivalent level. The existing Excessive Deficit Procedure will also be reinforced with automatic consequences, including possible sanctions, if a Eurozone member is in breach of the 3 per cent deficit ceiling (unless a qualified majority of members are in opposition).

EU member states agreed to provide €200 billion in bilateral loans to the International Monetary Fund's general resources, three-quarters of which will come from the Eurozone members. The coming into force of the European Stability Mechanism (ESM), the new €500 billion permanent rescue funds, will also be pushed forward to July 2012 (from 2013). The ESM statutes will also be revised to include an emergency procedure with a required qualified majority vote of 85 per cent replacing the mutual agreement rule.

Additional Resources

Follow the Eurozone crisis and other financial market news by signing up to our Financial Industry Week in Review newsletter or by visiting www.orrick.com.

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Eurozone withdrawal – Where is the emergency exit?

Unilateral withdrawal from the Eurozone

There is no mechanism under the Treaty of European Union (TEU), as amended by the Lisbon Treaty, for the unilateral withdrawal from the monetary union of a state which remains an EU member state. Such a step would constitute a breach of its treaty obligations, be unlawful as a matter of public international law, and may affect the legal analysis of any subsequent redenomination by the courts and tribunals of other EU member states. In particular, unilateral withdrawal may affect international recognition of subsequently passed domestic monetary legislation by the withdrawing state (see below).

Unilateral withdrawal from the EU

The Lisbon Treaty provided an exit mechanism for EU member states who wish to leave the EU. Article 50 of the TEU, as amended by the Lisbon Treaty, states that any member state may withdraw at its own will from the TEU in accordance with that state's own constitutional requirements. The departing member state will need to notify the European Council of its intention to withdraw, following which the EU and the withdrawing state will enter into negotiations and conclude a withdrawal agreement setting out the terms on which the state will withdraw from the TEU. Failing that, the TEU will cease to apply two years after notification.

Consensual withdrawal from the Eurozone

No mechanism exists under the TEU for the consensual withdrawal by one or more Eurozone member states from the Eurozone alone while still remaining a member of the EU. Such an approach would require treaty amendments by unanimous agreement among all EU member states.

Full break-up of the Eurozone

Again, a withdrawal from the Eurozone only (including by all members) is not contemplated by the TEU and the points made in the preceding paragraph are also relevant for an orderly (consensual) break-up or deconstruction of the Eurozone. On a national level, it would lead to the introduction of redenomination legislation in all currently 17 Eurozone states. Other than the legal issues raised by a break-up of the Eurozone it would also likely have significant effects on the economy within, as well as on the functioning of, the European Union.

Euro redenomination: "By failing to prepare, you are preparing to fail"

– Benjamin Franklin

A possible withdrawal by one or more states from the Eurozone raises the potential difficulty of determining whether a euro denominated obligation remains a euro obligation or if payment will need to be made in the new currency of the withdrawing state. The starting point is that questions on the interpretation and performance of obligations are generally determined by the law applicable to the contract. However, where an obligation is expressed in a particular national currency, the principle of *lex monetae* dictates that there is an implicit choice of law of that country to determine the denomination of the payment obligation. This widely recognized principle must usually be applied regardless of the law expressed to govern the obligation itself. The difficulty with the euro denominated obligations is that there is no single country designating the *lex monetae*; the euro is a supra-national enterprise.

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Question: What will happen to my euro denominated obligation that is subject to the laws of a withdrawing state?

Where the euro denominated obligation exists only within a withdrawing state, it is likely that the obligation will be redenominated to the state's new currency under new monetary legislation. Similarly, where the obligation provides for exclusive jurisdiction to the local courts, it is highly likely that the local courts will give effect to the new monetary legislation (and applicable exchange controls, if any) irrespective of whether Eurozone withdrawal was consensual or unilateral (and therefore unlawful).

Question: How does a Eurozone state's unlawful withdrawal from the euro affect the enforceability of my redenominated local debt obligation?

In the event of non-consensual (and therefore unlawful) Eurozone withdrawal, enforcement of a redenominated debt obligation in a foreign tribunal may prove problematic. Where the withdrawing state remains an EU member state, the Brussels I Regulation will apply and any decision by the local courts would be enforceable within an EU member state. However, this is subject to a general carve-out where it would be manifestly contrary to public policy to do so, something that a court may consider to be the case in the event of a unilateral Eurozone withdrawal.

Question: How will an English court look at my euro denominated obligation in the event of a redenomination?

Where an English court has jurisdiction over the debt obligation, the court will follow the Rome I Regulation (on the law applicable to contractual obligations in civil and commercial matters) and give effect to the governing law chosen by the parties. Article 3 of the Rome I Regulation provides that a contractual obligation is governed by the law chosen by the parties. Accordingly, where the governing law is that of the withdrawing state, an English court is likely to give effect to the withdrawing state's redenomination legislation. This is subject to any overriding mandatory laws in the UK and provided that to do so would not be manifestly incompatible with UK public policy (Articles 21 and 9 respectively of the Rome I Regulation). Again, the latter may be the case in the event of a non-consensual Eurozone withdrawal.

Where an English court is called on to apply English law as governing law to the euro denominated obligation, the analysis potentially becomes more problematic. As a general rule the contractual obligations would not be affected by the laws of the withdrawing state, including any redenomination legislation. However, whether a euro denominated obligation will be redenominated may ultimately come to depend upon the terms of the relevant contract (including the currency definition, payment mechanism and place of payment), the original contractual intention of the parties (although it is unlikely that the parties ever contemplated payment in any other denomination than the euro) and the circumstances of the withdrawal from (or breakup of) the euro. The legal analysis may also be influenced by future overriding EU legislation/treaty revisions aimed at an orderly restructuring (or deconstruction) of the Eurozone (see above).

Question: How will a New York State court look at my euro denominated obligation in the event of a redenomination?

Where a New York State court has jurisdiction over the debt obligation, in the first instance, the court will follow New York State law which provides that, generally, the parties to an obligation arising out of a transaction covering, in the aggregate, not less than $ 250,000 may agree that the laws of New York shall govern their rights and duties, whether or not such contract bears a "reasonable relationship" to New York State. If the parties to the debt obligation have not chosen New York law to apply, but the law of the withdrawing state, a New York court, generally, would (as would an English court) give effect to the withdrawing state's redenomination legislation. Again, this is subject to any overriding mandatory laws in New York State or US federal legislation, as well as public policy considerations.

Since the US is not a signatory to the treaties governing Eurozone withdrawal, a New York court is unlikely to consider whether the withdrawal of a particular state was consensual or unilateral when rendering a decision on redenomination, but will instead focus its analysis on conflict-of-laws principles and substantive contract law.

Where the parties have chosen New York law to apply to a Euro denominated obligation, a New York court would be likely to apply similar considerations to those referenced above with respect to a case presented to an English court in which the court applies English law.

Practical Advice

1. Financial and legal risk management

Banks and other financial institutions and corporates should take steps to identify existing financial and legal euro redenomination risks within their trades and transactions (both financial and commercial transactions), as well as within their operations, and to implement strategies and procedures for monitoring and managing such risks. The objective is to be in a position to quickly respond to any changes, for any reason, in the current Eurozone membership, including due to a withdrawal of one or more members, a broader break up or in other ways not currently contemplated.

2. Sovereign debt agreements

Review existing sovereign debt agreements in light of the different possible scenarios: what would be the effects on your sovereign exposures in the event of a withdrawal from (or break up of) the Eurozone? It will also be prudent to monitor sovereign credit ratings, in particular in light of Standard & Poor last week placing 15 of the Eurozone's 17 member states on a negative watch.

3. Material agreements review

Review existing agreements material to your business, including financing agreements (important for both lenders and borrowers), supporting guarantee, derivative (hedging) and insurance arrangements, paying particular attention to governing law and jurisdiction clauses, the currency of payment and place of payment clauses, and events of default provisions. In some circumstances (for example where a borrower is heavily dependent on revenue streams from a withdrawing state to service a debt obligation) a broadly worded material adverse change (MAC) clause may trigger an event of default if the MAC clause refers to the borrower's ability to perform its debt obligations under the arrangement.

4. New loans and other financing agreements and other contracts: revisit boiler-plate and payment obligation clauses

Firstly, ensure that satisfactory **governing law** and **submission to jurisdiction** clauses are incorporated into new agreements and consider the **material adverse change** and **events of default clauses** in light of possible scenarios. Consideration may also be given to an express termination clause in certain agreements in the event of withdrawal from or a break-up of the Eurozone.

Secondly, particular attention should be paid to the payments obligation clause, focusing on: (a) **currency definition:** ensure that an appropriate definition of the currency is used and, where euro denomination is intended, that no reference is made to the currency of a particular counterparty's home country; (b) **place of payment:** ensure that the place of payment is outside of any Eurozone member state that is of concern; (c) **pricing mechanism:** it may be appropriate to revise the pricing mechanism where reference is made to euro referenced base rates so as to avoid unnecessary uncertainty in the event the payment obligation is redenominated; (d) **redenomination risks:** ensure that where appropriate provisions addressing potential risks of currency redenomination are included, including a revised cost increase provision (for example risk of increased funding costs) and that if necessary any netting provision contemplates the possibility of different currencies following a redenomination.

5. Mergers & Acquisitions

A failure to consider the potential impact of negative developments in the Eurozone at the initial stage of an acquisition transaction may lead to difficulties at a later stage in the negotiations or have detrimental impact on its commercial viability post completion. It is therefore important that the financing terms of the transaction and equity commitments are given due consideration with particular reference to potential Eurozone scenarios. The due diligence process and drafting of documents should reflect the risks posed by a possible negative development in the Eurozone. Effective due diligence should ensure disclosure of risks in relation to assets or exposures related to Eurozone members or vulnerable banks, in particular European banks. With respect to documentation, particular attention should be given to any MAC clauses in the relevant documentation, and where desirable consider including specific wording that trigger an event of default in the case of a Eurozone withdrawal (or break up). The points raised above in relation to specific contractual provisions may also be relevant here.