The Eurozone Crisis and Financial Transactions

A comprehensive guide

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Field Fisher Waterhouse

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Speed read

1. It is not possible to insulate entirely against the risk of redenomination or exchange controls, except by winding down exposures.

2. Risks are greatest in the following cases:

i. local governing law
ii. local jurisdiction (even if in breach of jurisdiction clause)
iii. local insolvency proceedings
iv. local enforcement proceedings
v. place of performance located in jurisdiction affected by exchange controls
vi. intent of parties was to refer to currency of departing state.

3. Some (but not all) risks may potentially be mitigated by avoiding the above, e.g.:

i. choose foreign law (perhaps outside EU)
ii. choose foreign jurisdiction (perhaps outside EU)
iii. choose foreign place of performance
iv. take collateral (outside local jurisdiction and perhaps outside EU)
v. re-define "euro".

1. Background

The eurozone crisis shows no sign of easing. While it is likely that the euro and European Economic and Monetary Union (**EMU**) will survive, one or more countries may abandon the euro, with or without also leaving the European Union (**EU**). Some commentators continue to predict the collapse of the entire eurozone as a single currency area.

The economic effects of a country leaving the eurozone (**a departing state**) are unpredictable, both for that country and for those countries (if any) keeping the euro. One widely held expectation, however, is that the new national currency of a weak departing state may depreciate rapidly against the euro and other currencies.

The uncertainty of the nature of a eurozone fragmentation (that is, the number of departing states and whether the euro continues to exist) and the manner of such a fragmentation (that is, unilaterally or with the consensus of other member states of the eurozone or of the EU) makes any definitive legal analysis difficult. It will be necessary to review the documents and facts in each particular case. This publication is not a substitute for detailed advice on specific transactions and should not be taken as providing legal advice on any of the topics discussed. The purpose of this note is to consider in general terms some of the legal principles that may apply should a country leave the eurozone and to consider how those principles may apply to various types of finance arrangements.

2. The euro

The Member States of the EU committed to the process of EMU by the Maastricht Treaty signed on 7 February 1992. Prior to that, the European Currency Unit (**ECU**) had been used as a unit of account between EU institutions. The ECU was not a currency (in fact it was a weighted average of some, but not all, of the then-EU domestic currencies), but debt denominated in ECU was raised in the bond markets, and some loan facilities were denominated in ECU.

The euro replaced the currency of the original participating member states on 1 January 1999. During a transitional period, ending on 31 December 2001, the euro and the "old currencies" both existed, the old currencies being treated as units of the euro, with a fixed value against the euro, set at the beginning of the transitional period.

The change of currency was therefore signalled some years in advance, and commercial markets were given sufficient time to adjust to the transition to the euro.

There were some (not universally held) concerns that certain contracts might be frustrated or become impossible, despite the widely applicable legal principle that a monetary obligation cannot become impossible to perform by virtue of the currency in which the obligation is expressed ceasing to exist and being replaced by another currency. Article 3 of Council Regulation (EC) No 1103/97 nonetheless clarified this by providing that:

"The introduction of the euro shall not have the effect of altering any terms of a legal instrument or of discharging or excusing performance under any legal instrument, nor

give a party the right unilaterally to alter or terminate such an instrument. This provision is subject to anything which parties may have agreed."

Article 2 effectively told parties to ignore the change from the ECU to the euro, by providing that:

"Every reference in a legal instrument to the ECU … shall be replaced by a reference to the euro at a rate of 1 euro to 1 ECU."

The issuance of euros is controlled by the European Central Bank (**ECB**), which was also established by the Maastricht Treaty and is based in Frankfurt. It is part of a wider European System of Central Banks, comprising the ECB and the national central banks of the participating member states. The ECB authorises the issuance of euro bank notes by the national central banks of the participating member states, and approves the volume of issuances of coins by those member states.

3. Leaving the eurozone

There is no mechanism in the relevant EU treaties for a member state lawfully to abandon the euro and to adopt a new national currency. This reflects the intention when the euro was first created for membership of the eurozone to be permanent and irrevocable. A departing state would, it seems, have three options: to negotiate the departure by agreement with the other EU member states (we note that some commentators suggest that only the consent of those member states who have adopted the euro would be needed); to leave the EU entirely (it is generally considered that membership of the EU is a pre-requisite to membership of the eurozone); and unilateral exit of the eurozone in breach of the departing state's obligations under the relevant EU treaties. Departure would probably be accompanied by national or (in the case of a consensual exit) EU legislation regulating the legal consequences, and establishing the conversion rate or rates between the euro and a new currency adopted by the departing state. The manner of departure is likely to affect the legal consequences substantially.

4. Legal issues

A departure by one or more states from the eurozone would give rise to various legal issues, the most significant of which are described below. Whether some or all of these issues arise in respect of a particular contract will depend, in part, on whether laws are enacted (in any relevant jurisdiction), or market protocols introduced, to attempt to amend contractual terms to address the issues.

Any such law may purport to override the contractual rights and obligations of the parties, even if the parties had previously sought to address the issues in a different way. It is assumed for the purposes of this note that no such legislation or market protocol arises.

4.1 Redenomination - would payment obligations denominated in euro be redenominated into the new currency?

Summary box

What's the issue?	Risk that euro payment obligations are converted into new currency
What's the likelihood?	If local governing law / jurisdiction, high. Otherwise, unlikely in practice unless parties intended to refer to currency of departing state.
What's the uncertainty?	Low

A departing state is likely to pass legislation establishing monetary sovereignty and redenominating debts into a new currency. Such legislation may or may not specify precisely to which debts and obligations it applies (for example, it may simply state that all debts in the departing state are redenominated, leaving it to the markets and the courts to interpret which debts fall within that country). While arguments could be raised that the departing state should be liable for damages suffered by market participants as a result of redenomination, the ability of a market participant to obtain compensation is likely to be legally and practically limited.

There are three basic rules to determine whether a payment obligation denominated in one currency would be redenominated into another currency:

a. Local governing law - contracts governed by the law of a country are considered to be governed by the law of that country in effect from time to time. Since the departing state will introduce legislation

redenominating euro obligations, payment obligations under contracts governed by the law of the departing state will (if they fall within the scope of that legislation) be redenominated. The creditor must therefore accept payment in the new currency and would be unable to claim for payment in euro.

b. Local jurisdiction - if the dispute is to be heard in the courts of the departing state, then those courts will inevitably give effect to their own currency laws, even if the governing law of the contract is a foreign law.

   Proceedings may be initiated in the courts of the departing state in a number of circumstances, including:

   i. if permitted pursuant to the contractual agreement (for example, if the parties have submitted to the jurisdiction of the courts of the departing state or if the submission to an alternative jurisdiction is "non-exclusive");
   ii. if proceedings are commenced in contravention of an exclusive jurisdiction clause – while the courts of the departing state should decline jurisdiction (at least for so long as the departing state remains a member state of the EU and subject to EU conflict of laws legislation), they may be reluctant or slow to do so and may ultimately (and wrongly) accept jurisdiction. For so long as those courts consider or accept jurisdiction, the courts of no other EU member state may consider the matter; and
   iii. if enforcement proceedings are commenced in the local jurisdiction.

See also the discussion below relating to the potential impact of local insolvency proceedings. In these and other circumstances where proceedings are before local courts, those courts are likely to give effect to their own monetary laws and find that payment obligations are redenominated (to the extent that those payment obligations are within the scope of those monetary laws).

c. *Lex monetae* - a debt expressed in the currency of a country involves an obligation to pay the nominal amount of that debt in whatever is legal tender at the time of payment according to the law of the country in whose currency the debt is expressed (the *lex monetae*). This applies regardless of the law governing the contract from which the debt arises, and irrespective of any fluctuations that may have occurred in the value of that currency in terms of any other currency. There is an implicit choice of the law of the country of a currency to determine what that currency is. In general, therefore, if an obligation is denominated in the currency of a country and the local law of that country were to change its currency, the currency of the obligation will also convert. Courts outside that country will generally recognise the change of currency.

   A complication in the case of the euro is that it is not straightforward to apply the *lex monetae* principle to obligations expressed in a shared common currency, because the parties' intentions as to whether they intended to refer to the currency of a particular country (and, if so, which country) may not be clear. In addition, despite a departing state leaving the eurozone, the old currency (the euro) would still exist unless the eurozone were to break up completely.

4.2 Exchange controls – would payments be prohibited by exchange controls and, if so, what is the effect of those exchange controls on the rights and obligations of the parties?

Summary box

What's the issue?	Risk that courts uphold prohibition by departing state against making payment in euro
What's the likelihood?	Unlikely, but possible, in EU courts outside departing state
What's the uncertainty?	Medium

Any departure from the eurozone is likely to be accompanied by the imposition by the departing state of exchange controls or capital controls, possibly with little or no advance notice, to avoid funds denominated in euro being removed from the departing state. For example, the departing state may impose laws making it illegal for a person organised, incorporated or domiciled (or, perhaps, resident) in the departing state to make

payments denominated in euro to a person outside the departing state, or for any person to make payments denominated in euro in the departing state.

Exchange controls and capital controls are currently prohibited in the EU unless those controls are justified on the grounds of "public policy or public security". It is likely that the concept of public policy would be construed narrowly, particularly in the case of a unilateral exit from the eurozone or the EU in breach of the relevant EU treaties. Accordingly, a court in a member state of the EU (other than the departing state) would (subject to the discussion below regarding the Articles of Agreement of the IMF) be unlikely to recognise exchange controls imposed by the departing state.

Article VIII(2)(b) of the Articles of Agreement of the International Monetary Fund (the **IMF**) provides that exchange contracts involving the currency of any member of the IMF that are contrary to any exchange controls of that member shall, if those exchange controls are consistent with the Articles of Agreement, be unenforceable in the territories of any member. Accordingly, the courts of IMF member states (including the English courts) should not enforce exchange contracts that breach exchange controls imposed by an IMF member consistently with the Articles of Agreement. The current approach of the English courts is to interpret these provisions narrowly, in particular as to the definition of "exchange contracts".

In the context of the departure of a departing state from the eurozone, much attention has been given to Article VIII(2)(b). However, the scope of Article VIII(2)(b) appears to be limited to exchange controls imposed by a member in respect of its own currency, which in practice may be unlikely after the departing state has adopted the new currency (but could be possible beforehand) – the exchange controls are likely to relate to the euro, which after redenomination will no longer be the currency of the departing state.

In any event, in circumstances where exchange controls are recognised under the Articles of Agreement of the IMF but are prohibited by the EU treaties, there remains some doubt as to whether the English courts (or the courts of any other member state of the EU that is also a member of the IMF) would recognise and give effect to those exchange controls.

Additionally, in respect of proceedings in the courts of an EU Member State relating to a contract entered into on or after 17 December 2009, those courts may give effect to the overriding mandatory provisions of the law of the place of performance, insofar as those overriding mandatory provisions render performance unlawful. Similar rules apply to contracts entered into before this date in relation to proceedings in jurisdictions that are bound by the 1980 Rome Convention, although not in respect of proceedings before the English courts. Similarly, in relation to the manner of performance and the steps to be taken in the event of defective performance under contracts, courts in EU member states (or, in respect of contracts entered into before 17 December 2009, courts in jurisdictions that are bound by the Rome Convention) are to have regard to the law of the country in which performance takes place.

A number of questions arise in the context of these rules, including how to identify the place of performance (particularly where a contract involves reciprocal payment obligations, as to which see the discussion in relation to frustration below), what constitutes an overriding mandatory provision or question relating to "manner of performance", and how to determine the meaning of "may give effect to" or "have regard to". There is no certainty as to how these questions would be resolved in any particular fact pattern. However, subject to public policy considerations at the time (particularly in the case of a unilateral, non-consensual departure from the eurozone), it is possible to see how exchange controls or legislation giving effect to a currency redenomination might be considered to be overriding mandatory provisions of law. Subject to these crucial uncertainties, there remains, at least, the possibility that a court (including an English court) either gives effect to or has regard to the laws of the departing member state (if that is the place of performance) insofar as those laws affect the ability of a party to make a payment in euro.

4.3 Frustration and supervening illegality – would contracts be frustrated, either as a result of redenomination or as a result of exchange controls?

Summary box

What's the issue?	Risk that contract is terminated at no cost because illegal / impossible to perform
What's the likelihood?	Unlikely unless performance required in jurisdictions affected by illegality / impossibility.
What's the uncertainty?	Low

The essence of the doctrine of frustration is that parties to a contract are excused from performing their obligations if an unexpected, supervening event occurs affecting the essence of the contract and that renders performance impossible or illegal or makes it radically different from that contemplated by the parties at the time of the contract. If a frustrating event occurs, the contract is discharged such that the parties are not required to perform their future obligations (without prejudice to obligations that arose before the time of frustration). A contract will not be frustrated as a result of a supervening event if the contract deals with the consequences of the occurrence of that event.

As noted above, there were at the time that the euro was introduced some concerns as to whether certain contracts might be frustrated by the replacement of the domestic currencies of the soon-to-become eurozone member states, and European legislation was introduced to put the matter beyond doubt. While legislators had sufficient time upon adoption of the euro to introduce legislation along these lines, in the context of the departure of one or more departing states from the eurozone there is unlikely to be sufficient time to address the issues fully (or, if such legislation has been prepared, it is not yet in the public domain).

As such, the question remains as to whether a contract might be considered to be frustrated as a result of the adoption of a new domestic currency to replace the euro or as a result of exchange controls.

To conclude that a contract has been frustrated, the court must be satisfied not just that the supervening event affects the essence of the contract, but also that the event renders performance impossible, illegal or radically different from that originally intended by the parties. In particular, in respect of illegality and impossibility, the party alleging frustration must show that the only place of performance is the place in which it is illegal or impossible to perform. The rules identifying the place of performance of a payment obligation are, in broad terms, that the place of performance is the location of the receiving account. However, these rules were developed in respect of unilateral payment obligations, and there remains uncertainty as to how they would be applied in the context of reciprocal payment obligations (such as, for example, an interest rate swap).

In practice, if the place of performance is determined by reference to the location of the recipient's account, it is unlikely (assuming that the recipient is not itself organised in the departing state) that the only place of performance in respect of payment obligations owing *by* a borrower or counterparty in the departing state would be in the departing state. Accordingly, the risk of a borrower or counterparty located in the departing state alleging frustration may, in practice, be reduced.

Given the severe consequences of frustration, the English courts are typically reluctant to find that a contract is frustrated, preferring to assume that the parties' intention would be to keep the contract alive and find a way to give effect to those intentions.

4.4 Insolvency – could local insolvency law be used to effect redenomination and write-down of debts and, if so, would those insolvency laws be recognised in other jurisdictions?

Summary box

What's the issue?	Risk that insolvency law is used to redenominate / write down debt
What's the likelihood?	Posssible
What's the uncertainty?	Low - Medium

It is possible, if not likely, that many institutions in the departing state would become insolvent as a result of the consequent devaluation of its new currency as against the euro. In the case of ordinary trading corporations (that is, excluding insurance companies, credit institutions and investment banks), local insolvency proceedings must be recognised and given effect in English insolvency proceedings and in insolvency proceedings commenced in other EU member states (with the exception of Denmark). Similarly, in the case of credit institutions, reorganisation measures made by EU member states must be given effect under English law and under the laws of other EU member states. Accordingly, if the local insolvency laws in the departing member state were to permit the insolvency official to reduce or redenominate debt and the insolvency official takes such action, courts in other member states of the EU may (subject to certain safeguards) be required to recognise such action.

In addition, in most countries a debt payable in a foreign currency is converted into the local currency if the debtor enters insolvency proceedings. It is typically not possible to contract out of this. Accordingly, a creditor of a person subject to insolvency proceedings in the departing state is likely to be required to prove in the new currency.

4.5 Suspension or termination rights – do any contractual suspension or termination rights arise as a result of redenomination or non-payment?

If provisions to this effect are included in the parties' contractual agreement, either or both parties may have the ability either to suspend payments or to terminate the contract as a result of the redenomination or any exchange controls.

5. Legal issues: loan agreements

Loan agreements do not typically contain standard provisions governing the departure of a member state from the eurozone, and a change of currency will not usually be included as an event of default. A failure to pay in euro may, however, give rise to rights to accelerate the loan.

5.1 Basic case

A useful starting place may be to consider the following fact pattern: a single departing state leaves the eurozone (with the euro continuing to exist as the lawful currency of the remaining member states of the eurozone) and introduces domestic legislation redenominating obligations into a new currency and introducing exchange controls; a borrower incorporated in the departing state has borrowed funds in euro under a loan facility governed by English law; the borrower has submitted to the exclusive jurisdiction of the English courts; "euro" is defined in the facility agreement as the single currency of the eurozone; the place for performance is outside the departing state; and failure to pay is specified as an event of default under the facility agreement.

On these facts, the analysis is likely to be as follows:

a. Redenomination

   i. The change in domestic law does not have the effect of amending the terms of the loan, which is governed by English law.

   ii. Since the choice of English jurisdiction is exclusive, if the departing state remains in the EU, this should limit the risk of proceedings lawfully being brought in local courts of the departing state (but see the discussion above regarding circumstances in which proceedings

may nonetheless be commenced in that jurisdiction, in particular the risk of proceedings being commenced in breach of the jurisdiction clause).

iii. The definition of "euro" suggests an intention (for purposes of determining the *lex monetae*) that payments should remain denominated in euro.

b. Exchange controls – since the place of performance is outside the departing state, any exchange controls are unlikely to be relevant for purposes of EU legislation concerning overriding mandatory provisions or the manner of enforcement. The scope of the Articles of Agreement of the IMF and their interaction with the EU treaties remains unclear.

c. Frustration and supervening illegality - since the place of performance is outside the departing state, the contract is unlikely to be frustrated, as performance is not impossible or illegal in the place of performance (assuming that the place of performance is itself not a jurisdiction that would be bound to recognise the exchange controls).

d. Insolvency – the risk of local insolvency proceedings as described above continues to exist.

e. Termination rights - subject to the uncertainty regarding the Articles of Agreement of the IMF and the possibility of local insolvency laws being used to alter the underlying debt, the English courts are likely to hold that the loan remains payable in euro, and that a failure to make payment in euro will be an event of default, subject to any applicable notice or grace periods.

The facility agreement may also contain a material adverse change event of default that, depending on the terms of the clause and the circumstances, may be triggered as a result of the redenomination or exchange controls. Exchange controls introduced by a departing state may also result in an illegality event of default if, for example, the borrower cannot obtain the necessary central bank consent to make payment in euro. Action taken by the departing state might also result in the borrower breaching repeating representations and warranties, such as those dealing with non-conflict with law or regulation. Bankruptcy events of default may also be triggered.

5.2 Alternative fact patterns

If any of the facts described above were to be different, the outcome may also be different.

For example, if the governing law is that of the departing state, the English courts will give effect to the departing state's redenomination of currency, unless to do so is contrary to overriding English laws or English public policy. It is unlikely that redenomination is contrary to overriding public policy, save perhaps if the departing state has acted in a way clearly contrary to an EU treaty.

If there is no definition of "euro" in the loan agreement, an argument may be raised (if circumstances support the argument) that the *lex monetae* is the currency of the departing state. If there is no definition of "euro", but the place of payment is within the departing state, there is a rebuttable presumption that the parties intended the currency of payment to be the currency from time to time of the departing state. Nonetheless, in many cases it will be apparent from the arrangements that, taken as a whole, the parties' intention was to refer to the single currency of the eurozone, even if the membership of the eurozone were to shrink, and that the payment obligation should not be redenominated.

If the only place of payment is in the departing state and performance is illegal or impossible in that place, arguments may be raised that the contract is frustrated or otherwise that foreign courts should give effect to the local law (and therefore conclude that payment in euro is not required) on the basis that such local law is an overriding mandatory law of the departing state. However, as noted above, this may in practice be unlikely.

Should the euro collapse completely, and be replaced by several currencies, the position is likely to be uncertain. In theory, euro denominated obligations might be redenominated into a basket of currencies, but it is also possible that a debt originally payable in euro would be converted into the currency of the country with which the contract was most closely connected. The position might also be likely to be covered by new legislation.

6. Legal issues: ISDA Master Agreements

ISDA Master Agreements do not contain standard provisions governing the departure of a member state from the eurozone, and a change of currency will not usually be included as an event of default or termination event. Exchange or capital controls imposed by a departing state may, however, result in a termination event such as illegality or force majeure, or in a disruption event pursuant to a relevant ISDA definitions booklet.

The analysis is complicated by the variety of asset classes and accompanying standard form documentation that may be involved, and by the fact that a derivative transaction is likely to involve two-way payment obligations. Unlike a loan agreement, the currency of payment may also be the subject matter of the transaction (either expressly or commercially) – for example in the case of a currency swap – meaning that arguments for frustration may be stronger. Other potentially difficult fact patterns include a derivative transaction denominated in euro that hedges an income stream or liabilities that are redenominated into another currency, or that exchanges cashflows in euro for the return on a portfolio of underlying assets whose currency is redenominated.

6.1 Basic case

A useful starting place may be to consider the following fact pattern: a single departing state leaves the eurozone (with the euro continuing to exist as the lawful currency of the remaining member states of the eurozone) and introduces domestic legislation redenominating obligations into a new currency and introducing exchange controls; a counterparty incorporated in the departing state has entered into a series of vanilla fixed-to-floating euro-denominated interest rate swaps under an ISDA Master Agreement governed by English law; each confirmation incorporates the 2006 ISDA Definitions and the Termination Currency is specified to be euro.

On these facts, the analysis is likely to be as follows:

a. Redenomination
    i. The change in domestic law does not affect the terms and conditions of the ISDA Master Agreement, which is governed by English law.
    ii. In the case of a 1992 ISDA Master Agreement, the jurisdiction of the English courts is exclusive within the EU. If the departing state remains in the EU, this should limit the risk of proceedings lawfully being brought in local courts of the departing state (but see the discussion above regarding circumstances in which proceedings may nonetheless be commenced in that jurisdiction, in particular the risk of proceedings being commenced in breach of the jurisdiction clause). In the case of an ISDA 2002 Master Agreement, the jurisdiction of the English courts is non-exclusive within the EU and so the risk of local proceedings being commenced in the departing state is greater.
    iii. For the purposes of determining the *lex monetae*, in respect of payments under the individual transactions, "euro" is defined in the 2006 ISDA Definitions as being the lawful currency of the member states of the EU that adopt the single currency in accordance with the EC Treaty, which suggests an intention that payments should remain denominated in euro. In respect of payment of the net sum (if any) due upon close-out of the ISDA Master Agreement, the standard ISDA Master Agreement does not contain a definition of "euro", but save in exceptional circumstances it is unlikely that there would be facts supporting a suggestion that the intention of the parties was to refer to the lawful currency for the time being of the departing state.
b. Exchange controls – exchange controls may be relevant for purposes of EU legislation concerning overriding mandatory provisions or the manner of enforcement if those exchange controls are effective in the place of performance. It may be difficult to identify with any certainty the place of performance, since the rules for determining the place of performance were developed for one-way obligations, rather than reciprocal obligations such as those under an ISDA Master Agreement. The scope of the Articles of Agreement of the IMF and their interaction with the EU treaties also remains unclear.
c. Frustration and supervening illegality – as noted above, it may be difficult to identify with any certainty the place of performance. Note in this regard that the ISDA Master Agreement permits either party to change its account for receiving payments or deliveries by giving notice to the other party, and so the place of performance (if linked to the receiving account) could be subject to change. Subject to this,

it may be difficult to suggest that the only place of performance is a jurisdiction in which the exchange controls render payment impossible or illegal. Also note that if the exchange controls otherwise give rise to a right to terminate in accordance with Illegality or Force Majeure Event (as to which, see below), the contract will not be frustrated. In this regard, it is worth noting that Illegality and Force Majeure Event apply only to payments and deliveries under transactions, and do not apply to a party's inability to pay a net sum upon close-out.

d. Insolvency – the risk of local insolvency proceedings as described above continues to exist.

e. Suspension and termination rights

   i. Failure to Pay - Subject to the uncertainty regarding the Articles of Agreement of the IMF and the possibility of local insolvency laws being used to alter the underlying debt, the English courts are likely to hold that payments remain payable in euro.

      The ISDA Master Agreement provides that payment obligations denominated in a currency (in this instance, euro) (**the contractual currency**) are required to be made in the contractual currency and will not be discharged by the tender of another currency, except to the extent that such tender results in the actual receipt by the recipient, acting in good faith and using commercially reasonable procedures (or, in the case of the 1992 version, acting in a reasonable manner and in good faith) in converting the currency so tendered, of the full amount of the contractual currency. As such, the tender by a party of the new currency of the departing state instead of euro may not immediately and of itself constitute a failure to pay without regard to the extent to which the recipient is able to convert the new currency into euro. There is likely to be some uncertainty as to the extent of the recipient's obligation to attempt to convert the new currency into euro (for example, over which time period must it attempt to convert and at which rate if the official exchange rate is over-inflated, as would be the expectation in the case of a departing state).

      Subject to the foregoing, upon the occurrence of a failure to pay, the non-defaulting party's payment and delivery obligations under the ISDA Master Agreement (including in respect of unaffected transactions) are suspended and, if the failure is not remedied prior to the expiry of the applicable grace period, the non-defaulting party may terminate all (but not less than all) outstanding transactions under the ISDA Master Agreement.

   ii. Illegality and Force Majeure - exchange controls introduced by a departing state may result in an Illegality or (in the case of an ISDA 2002 Master Agreement) Force Majeure Event. Whether an Illegality or Force Majeure Event has occurred and, if so, the consequences of that event will depend on whether the 1992 or 2002 Master Agreement is used.

      Note that if the cause of the illegality or force majeure is a party's failure to obtain authorisation to make payment, that illegality may be an Event of Default rather than a Termination Event.

      In the 2002 version, an Illegality or a Force Majeure Event may occur if it becomes illegal (or impossible or impracticable, as applicable) for a party to make or receive payments through the office through which it makes or receives payments in respect of a transaction. Accordingly, under the 2002 version, it is not necessary that it should be unlawful, impossible or impracticable (as applicable) for the party to make or receive payments in all jurisdictions through which that party operates its businesses, but only in the office *through which it makes or receives payment in respect of the relevant transaction*. As such, if the exchange controls render it unlawful for the party to make or receive payments in the particular office through which that party makes or receives payments in respect of a transaction, an Illegality or Force Majeure Event (as applicable) will have occurred. The parties must wait for three local business days (in the case of an Illegality) or eight local business days (in the case of a Force Majeure Event) before the affected transactions can be terminated. All payment and delivery obligations in respect of the affected transactions (including those payments and deliveries that are not themselves illegal or

impossible to make or receive) are suspended during the waiting period, but the suspension ceases at the end of that period if the affected transactions are not terminated.

In the 1992 version, the Illegality Termination Event (there is no Force Majeure Event provision in the 1992 version) arises if it becomes unlawful for a party to make or receive payments. The 1992 ISDA Master Agreement does not expressly permit a party to terminate simply because the individual office through which it makes or receives payments in respect of a transaction is no longer able to do so. Instead, as a condition to its right to close out, the relevant party is required to use all reasonable efforts to attempt to transfer the transaction(s) to another office or affiliate to try to avoid the illegality (or, if both parties are affected by the illegality, the parties must try to agree on action to avoid the illegality). As such, if the exchange controls render it unlawful for the party to make or receive payments in a particular office, that party must use all reasonable efforts to transfer the affected transactions to another office or affiliate (or agree action with its counterparty, as applicable) before it is permitted to terminate those transactions. There is no suspension of payments or deliveries in these circumstances under the 1992 ISDA Master Agreement.

iii. Consideration should also be had as to whether other Events of Default may have been triggered, such as Bankruptcy or Cross Default.

6.2 Alternative fact patterns

If any of the facts described above were to be different, the outcome may also be different. In particular, the nature of and circumstances surrounding the individual transactions may affect the extent to which the *lex monetae* principle would be applied.

For example, a credit derivative transaction incorporating the 2003 ISDA Credit Derivatives Definitions does not (unless it also incorporates another definitions booklet such as the 2006 ISDA Definitions) contain a definition of "euro". As such, other circumstances may support an argument that the intention of the parties was to refer to the lawful currency of the departing state.

Similarly, the fact that a transaction was entered into specifically for the purpose of hedging an asset or liability that was, at the time, denominated in euro but that has itself been redenominated may support an argument that the intention of the parties was to refer to the lawful currency of the departing state.

In the case of an FX transaction or a currency option transaction, in each case that incorporates the 1998 FX and Currency Option Definitions, exchange controls may result in the occurrence of a Disruption Event (such as Specific Inconvertibility or Specific Non-Transferability, if applicable to the transaction). In these circumstances, the applicable Disruption Fallbacks specified to apply to that transaction will determine the consequences of the exchange controls, and those Disruption Fallbacks will prevail over the Illegality or (in the case of an ISDA 2002 Master Agreement and assuming the parties have amended the 1998 FX Definitions in the manner anticipated by the ISDA 2002 Master Agreement Protocol) Force Majeure Event provisions in the ISDA Master Agreement. Other disruptions and fallbacks may be applicable to other transaction types, depending on the definitions booklet incorporated by reference into the confirmation.

6.3 Other issues

If some euro-denominated obligations under the ISDA Master Agreement were to be redenominated into the new currency of the departing state while others were to remain denominated in euro, the parties would lose the benefit of the payment netting provisions under the ISDA Master Agreements, which provide for net settlement of amounts that would otherwise be payable in the same currency on the same day. This risk is likely to be more pronounced to the extent that parties have elected for cross-transaction payment netting to apply (as the risk of some, but not all, euro-denominated payment obligations under a single transaction being redenominated would appear to be remote).

The departing state may enact laws that purport to affect netting or convert claims (for the purpose of proving in bankruptcy) at an unfavourable rate of exchange. The effect, if any, of such laws will depend on the nature of the counterparty (which will determine whether any European cross-border insolvency legislation applies), whether the departing state remains in the EU and whether any safeguards apply to protect netting. Given the various alternatives that may apply, such issues are beyond the scope of this note.

In relation to credit support, obligations to deliver cash collateral are likely to be subject to many of the considerations set out earlier in this note. The analysis is more complicated for non-cash collateral denominated in euro, since account would also have to be taken of the redenomination of the assets themselves. The redenomination of an asset may cause an asset to cease to be eligible credit support.

7. Legal issues: repos and securities lending transactions

Global Master Repurchase Agreements (**GMRAs**) and Global Master Securities Lending Agreements (**GMSLAs**) do not contain standard provisions governing the departure of a member state from the eurozone, and a change of currency will not usually be included as an event of default. Exchange or capital controls imposed by a departing state may, however, result in termination rights.

7.1 Basic case

A useful starting place may be to consider the following fact pattern: a single departing state leaves the eurozone (with the euro continuing to exist as the lawful currency of the remaining member states of the eurozone) and introduces domestic legislation redenominating obligations into a new currency and introducing exchange controls; a counterparty incorporated in the departing state has entered into a repurchase transaction under a GMRA or a securities lending transaction under a GMSLA, in each case governed by English law; the repo'd or loaned securities are denominated in euro and the purchase price (in the case of a repo) or cash or securities collateral (in the case of a securities lending transaction) are also denominated in euro.

On these facts, the analysis is likely to be as follows:

a. Redenomination
    i. The change in domestic law does not affect the terms and conditions of the GMRA or GMSLA, which are governed by English law.
    ii. In the case of the 2000 GMSLA, the 2010 GMSLA and the 2011 GMRA, the jurisdiction of the English courts is exclusive. If the departing state remains in the EU, this should limit the risk of proceedings lawfully being brought in local courts of the departing state (but see the discussion above regarding circumstances in which proceedings may nonetheless be commenced in that jurisdiction, in particular the risk of proceedings being commenced in breach of the jurisdiction clause). In the case of a 2000 GMRA, the jurisdiction of the English courts is non-exclusive and so the risk of local proceedings being commenced in the departing state is greater.
    iii. If the repo'd or loaned securities or collateral or margin in the form of securities are redenominated, it is likely that the redenominated securities will continue to be "equivalent" to the original securities and that the obligation to return equivalent securities will apply to those securities as redenominated.
    iv. For the purposes of determining the *lex monetae* of payment obligations such as the repurchase price or cash collateral, the standard GMRA and GMSLA do not contain a definition of "euro". Save in exceptional circumstances it is unlikely that there would be facts supporting a suggestion that the intention of the parties was to refer to the lawful currency for the time being of the departing state. It is possible that an argument may be raised that the intention of the parties at the time of entering into the transaction was that the payment obligations should correspond to the currency of the securities (although note that the GMRA requires payment of the Repurchase Price to be in the same currency as the Purchase Price). However, if the repo or securities lending transaction were to be analysed as, economically, a collateralised funding arrangement, a redenomination of the repurchase price or cash collateral to match the denomination of the securities would lead to an unusual commercial result. This would be that the party providing financing (the repo buyer or securities borrower) would lose its claim to repayment of the funds in the original currency simply because the collateral (the repo'd or loaned securities) is redenominated. If this analysis were correct, redenomination of the collateral would have the effect of writing down both the value of the collateral and the underlying debt. Accordingly, in relation to payment obligations and save in exceptional circumstances, it is unlikely that payment obligations would be redenominated simply to match redenominated securities.
b. Exchange controls – any exchange controls may be relevant for purposes of EU legislation concerning overriding mandatory provisions or the manner of

enforcement if those exchange controls are effective in the place of performance. It may be difficult to identify with any certainty the place of performance, since the rules for determining the place of performance were developed for one-way obligations, rather than reciprocal obligations such as a GMRA or GMSLA. The scope of the Articles of Agreement of the IMF and their interaction with the EU treaties remains unclear.

c. Frustration and supervening illegality – as noted above, it may be difficult to identify with any certainty the place of performance. However, it may be difficult to suggest that the only place of performance is a jurisdiction in which the exchange controls render payment impossible or illegal.

d. Insolvency – the risk of local insolvency proceedings as described above continues to exist.

e. Suspension and termination rights

    i. Failure to Pay - Subject to the uncertainty regarding the Articles of Agreement of the IMF and the possibility of local insolvency laws being used to alter the underlying debt, the English courts are likely to hold that payments remain payable in euro. Subject to the foregoing, upon the occurrence of a failure to pay, the non-defaulting party's payment and delivery obligations (including in respect of unaffected transactions) under a 2000 GMRA or 2011 GMRA in respect of which Paragraph 6(j) applies are suspended. No equivalent provision applies in respect of a GMSLA. In all cases, if the failure is not remedied prior to the expiry of the applicable grace period, the non-defaulting party may terminate all (but not less than all) outstanding transactions under the GMRA or GMSLA.

    ii. Change in law – In the case of the GMRA, the Tax Event provision appears to be drafted sufficiently broadly such that a change in law that has a material adverse effect on a party in the context of a transaction may give that party a termination right (subject to certain conditions being satisfied). If this provision were to be interpreted broadly, the imposition of exchange controls could result in a party having the right to terminate the affected transaction (although termination requires settlement of redelivery and repayment obligations). However, it is thought that the Tax Event provisions are intended to cover changes in tax (or, perhaps, accounting or regulatory capital) laws rather than all laws generally. In the case of the GMSLA, unless the confirmation provides otherwise, all transactions are on demand and so either party may be entitled to terminate a transaction for any reason (although termination requires settlement of redelivery and repayment obligations).

    iii. Misrepresentation – under the GMRA, each party represents that performance by it of its obligations will not violate any law to which it is subject. This representation is repeated (amongst other things) on each date on which margin is to be transferred. On a strict interpretation, the counterparty may therefore be deemed to represent that its obligations under the GMRA (including all future payment obligations) remain lawful if either party is required to transfer margin on or after the date of redenomination (which, given the likely fluctuation in values of the underlying assets, is perhaps likely). Such representation is likely to be inaccurate if exchange controls are introduced preventing the counterparty from performing its payment obligations denominated in euro. Similarly, under the GMSLA each party represents that it is not restricted under the terms of its constitution or in any other manner from performing its obligations under the GMSLA. This representation is repeated on an ongoing basis. Again, such representation is likely to be inaccurate if exchange controls are introduced preventing the counterparty from performing its payment obligations in euro. In each case, misrepresentation is an event of default.

    iv. Consideration should also be had as to whether other Events of Default may have been triggered, such as an Act of Insolvency.

7.2 Alternative fact patterns

If any of the facts described above were to be different, the outcome may also be different.

For example, a repo or securities lending transaction in which the currency of the securities and the currency of the collateral are not the same would suggest that the risk of redenomination of the cash payments to match the currency of the securities is even less likely.

8. Legal issues: bonds

The bond market does not operate on the basis of recommended form documentation, reinforcing the need to review the terms of the bonds in question. However, bonds do not typically contain standard provisions governing the departure of a member state from the eurozone, and a change of currency will not usually be included as an event of default. A failure to pay in euro may, however, give rise to a right to accelerate the debt.

8.1 Basic case

A useful starting place may be to consider the following fact pattern: a single departing state leaves the eurozone (with the euro continuing to exist as the lawful currency of the remaining member states of the eurozone) and introduces domestic legislation redenominating obligations into a new currency and introducing exchange controls; an issuer incorporated in the departing state has issued unsecured bonds denominated in euro; the bonds are governed by English law; the borrower has submitted to the non-exclusive jurisdiction of the English courts; "euro" is defined in the terms and conditions as the single currency of the eurozone; the place for performance is outside the departing state; and failure to pay is specified as an event of default under the terms and conditions of the bonds.

On these facts, the analysis is likely to be as follows:

a. Redenomination
    i. The change in domestic law does not have the effect of amending the terms of the bonds, which are governed by English law.
    ii. Since the choice of English jurisdiction is non-exclusive, if the departing state were to remain in the EU, there remains a risk of proceedings being commenced in the departing state.
    iii. The definition of "euro" suggests an intention (for purposes of determining the *lex monetae*) that payments should remain denominated in euro.
b. Exchange controls – since the place of performance is outside the departing state, any exchange controls are unlikely to be relevant for purposes of EU legislation concerning overriding mandatory provisions or the manner of enforcement. The scope of the Articles of Agreement of the IMF and their interaction with the EU treaties remains unclear.
c. Frustration and supervening illegality - since the place of performance is outside the departing state, the bonds are unlikely to be frustrated, as performance is not impossible or illegal in the place of performance (assuming that the place of performance is itself not a jurisdiction that would recognise and be bound to recognise the exchange controls).
d. Insolvency – the risk of local insolvency proceedings as described above continues to exist.
e. Termination rights - subject to the uncertainty regarding the Articles of Agreement of the IMF and the possibility of local insolvency laws being used to alter the underlying debt, the English courts are likely to hold that the bonds remain payable in euro, and that a failure to make payment in euro will be an event of default, subject to any applicable notice or grace periods.

    The terms and conditions may also contain a material adverse change event of default that, depending on the terms of the clause and the circumstances, may be triggered as a result of the redenomination or exchange controls. Action taken by the departing state might also result in the borrower breaching repeating representations and warranties, such as those dealing with non-conflict with law or regulation. Bankruptcy events of default may also be triggered.

8.2 Alternative fact patterns

If any of the facts described above were to be different, the outcome may also be different.

For example, if the governing law is that of the departing state, the English courts will give effect to the departing state's redenomination of currency, unless to do so is contrary to overriding English laws or English public policy. It is unlikely that redenomination is contrary to overriding public policy, save perhaps if the departing state has acted in a way clearly contrary to an EU treaty.

If there is no definition of "euro" in the terms and conditions, an argument may (if circumstances so permit) be raised that the *lex monetae* is the currency of the departing state. If there is no definition of "euro", but the place of payment is within the departing state, there is a rebuttable presumption that the parties intended the currency of payment to be the currency from time to time of the departing state. Nonetheless, in many cases it will be apparent from the arrangements that, taken as a whole, the parties' intention was to refer to the single currency of the eurozone, even if the membership of the eurozone were to shrink, and that the payment obligation should not be redenominated.

If the place of payment is in the departing state and performance is illegal or impossible in that place, arguments may be raised that the bonds are frustrated or otherwise that foreign courts should give effect to the local law (and therefore conclude that payment in euro is not required) on the basis that such local law is an overriding mandatory law of the departing state.

Should the euro collapse completely, and be replaced by several currencies, the position is likely to be uncertain. In theory, euro denominated obligations might be redenominated into a basket of currencies, but it is also possible that a debt originally payable in euro would be converted into the currency of the country with which the contract was most closely connected. The position might also be likely to be covered by new legislation.

9. Other legal issues

In addition to the foregoing, other issues may arise as a result of the adoption of a new currency and the imposition of exchange controls. While these issues are unlikely to affect the enforceability of the contractual arrangements, they may have important consequences as to the timing and nature of the parties' obligations.

a. local business days – disruption may be expected to occur in certain markets, potentially affecting what constitutes a good business day;
b. disruption to pricing sources, indices and markets – these may adversely affect index-linked (or similar) products or the setting of rates;
c. business day conventions, day count fractions and other conventions – if payment obligations are redenominated, these may also need to be adjusted to reflect any differences in market practice;
d. currency indemnities - these may assist a creditor if judgment is given in a new national currency while the payment obligation remains denominated in euro. There is, however, some uncertainty as to the effectiveness of such provisions, and in any event they are unlikely to offer any protection against redenomination risk; and
e. guarantees - if a guarantee has been given by an obligor in the departing state, there may be circumstances where the debt remains denominated in euro but the guarantor's obligations are redenominated.

10. Possible amendments

This note does not seek to identify whether it is preferable for parties to amend their documentation or, if so, how to do so. Any such analysis will depend on the party's exposure to euro and to the departing state (which may be difficult to identify, particularly in the case of master agreements governing multiple trading exposures) and whether the new currency of the departing state is stronger or weaker than the euro. As will be apparent from the discussion above, the analysis as to the consequence of a departing state leaving the eurozone and introducing exchange controls depends to a large extent on various provisions in the parties' contractual arrangements – amendments to those provisions may potentially improve (or, depending on the direction of the exposure, worsen) the position of either party. The following list identifies some of those contractual provisions and the potential impact that changes to those provisions may have:

a. definition of currency (for example, to refer to the currency of the eurozone or to the currency of a particular member state) - may assist in determining the *lex monetae*
b. governing law - choosing the governing law of the departing state will inevitably result in redenomination; choosing a governing law within the EU may be detrimental (for example, cross-border insolvency recognition) or beneficial (for example, recognition of enforcement of judgments);
c. submission to jurisdiction: exclusive jurisdiction clauses in favour of courts outside the departing state are likely to reduce (but not eliminate) the risk of proceedings in local courts;
d. payment mechanics: clarifying that payment is to be made outside the departing state may assist in issues relating to place of performance (such as frustration and overriding mandatory provisions); and
e. termination rights: if appropriate, consider including express termination rights if there is a redenomination or another relevant event. Also consider improving existing termination rights (for example, amending 1992 ISDA Master Agreements to include the broader Illegality and Force Majeure provisions of the ISDA 2002 Master Agreement).

11. Other steps

Parties are likely to have started to establish which transactions are likely to be affected by a particular departing state or by wider issues concerning the survival of the euro. Parties may also have reduced exposures to certain jurisdictions. They should continue to review how financing arrangements have been documented, including the elections contained in any schedules, confirmations and definitions booklets (where applicable), related credit support, guarantees, security, hedges and credit protection.

Parties may also consider ensuring, to the extent commercially feasible, that exposures to departing states are collateralised and that collateral is held in a jurisdiction that is unlikely to be affected by the relevant events.

Such steps should improve the relevant party's position if urgent action becomes necessary. Depending on the transaction and circumstances, however, the practical scope for amending the documentation by agreement may be limited.

Contacts

Oliver Abel Smith
Partner
t: +44 (0)20 7861 4855
e: oliver.abelsmith@ffw.com

Robert Cooke
Partner
t: +44 (0)20 7861 4965
e: robert.cooke@ffw.com

Andrew Evans
Partner
t: +44 (0)20 7861 4169
e: andrew.evans@ffw.com

Gonzalo Fernandez
Partner
t: +44 (0)20 7861 4906
e: gonzalo.fernandez@ffw.com

Daniel Franks
Partner
t: +44 (0)20 7861 4229
e: daniel.franks@ffw.com

Ronit Grant
Partner
t: +44 (0)20 7861 4604
e: ronit.grant@ffw.com

Edward Miller
Partner
t: +44 (0)20 7861 4205
e: edward.miller@ffw.com

Guy Usher
Partner
t: +44 (0)20 7861 4209
e: guy.usher@ffw.com