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A Eurozone Break-up: Potential Legal Pitfalls

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Summary of talk

- History behind the creation of the Euro and importance in context setting
- Redenomination: relevant legal principles
- The possible scenarios – complete, partial; legal or illegal departures/break-up
- Implications for Euro denominated funds and contracts
- Contingency Planning: what should you be doing now?

Creation of the Euro

- The Euro can be said to have been foreseen even in the original European Economic Community Treaty of 1957 which described its objectives as including:

  "… to promote throughout the Community a harmonious development of economic activities [and]…an increase in stability… by establishing a common market and progressively approximating the economic policies of Member States…[including] the abolition of obstacles to freedom of movement of …capital … and the application of procedures by which economic policies …can be co-ordinated and disequilibria in their balances of payments remedied."

Creation of the Euro

- In 1973 the "currency snake" came into being with the establishment of the European Monetary Co-operation Fund to intervene in the markets as necessary to ensure Member States currencies fluctuated within a narrow 2.25%

- And various Community institutions were set up and adopted measures to encourage convergence of economic policies

Creation of the Euro

- The “currency snake” was replaced by the European Currency Unit (**ECU**) in 1979 along with the creation of the Exchange Rate Mechanism (**ERM**).

- The ERM was, in one sense, merely another version of the "currency snake" with each Member State currency forming a weighted proportion of a single ECU

Creation of the Euro

- But, as the exit of Sterling on "Black Wednesday" on 16 September 1992 showed, there was in fact no clear commitment or duty on the part of all Community central banks to intervene

- Bank of England was unable ***alone*** to provide enough support to prevent Sterling falling through its agreed floor, despite raising interest rates from 10% to 15% in a single day!

- Importantly, there was an obligation on EU central banks to 'intervene' in the markets if and when these limits were reached

- The ECU was never, of course, a separate currency. No notes or coins were issued and only it was used only as a means of settling obligations between Member States of the Community itself.

Creation of the Euro

- Member States were obligated to deposit 20% of their gold reserves and their US Dollar reserves in return for credits expressed in ECU

- Purpose was largely to encourage Member States to follow monetary, fiscal and economic policies which ensured their currencies remained stable against each other with a view to minimising disruptions to trade within the Community

Creation of the Euro

- The first significant step towards actual monetary union came with the Treaty on European Union (signed in February 1992 in Maastricht) and effective 1 November 1993

- One of its primary objectives was: "…the creation of … an economic and monetary union, ultimately including a single currency…".

- The Treaty envisaged a three stage process culminating with a single currency by 1 January 1999

Creation of the Euro

- Stage 2 involved, inter alia, "…continued pursuance of economic policies to achieve monetary union by 1999"
- Taking steps to 'endeavour to avoid excessive government deficits' (but with no sanctions against offenders)
- The establishment of independent central banks by each Member State
- The establishment of the European Monetary Institute as a precursor to the establishment of the European Central Bank

Creation of the Euro

- At the end of this process a list of Member States which qualified to be included in the Eurozone would be agreed

- The tests to be applied for Eurozone membership became known as the "Maastricht Criteria“, which included:

  - a high degree of price stability; no excessive government deficits; compliance within the ERM for at least two years without devaluation; and long term interest rates on government debt comparing favourably with best performing Member States

Creation of the Euro

- In the event, at the end of the process, the Maastricht Criteria were agreed not to be hard and fast rules but merely a reference or starting point; and longer term "sustainable convergence" was said to be the (less than) acid test against which the Commission was to judge applicants

- The "excessive deficit" test was, therefore, formally waived in respect of certain Member States; the accounting methods used by others to (apparently) meet the Maastricht criteria were known to be dubious

- Italy had not conformed to the ERM test

Creation of the Euro

- The birth of the Euro, like so many other EU legislative initiatives, bore the mark of compromise, couched in ambiguous language designed to start the single currency initiative and with its final shape to be determined as time went by

- And in the hope that it would all turn out right in practice!

Creation of the Euro

- To support the single currency a series of economic measures were established with the aim of encouraging sound government finances, budgetary discipline and a stable monetary environment

- This included a “Stability and Growth Pact” designed to be a framework for enforcement of these high level objectives

- Member States were required to conform their economic policies to guidelines established by the Council and to keep the Council informed and co-ordinate such policies with the Council.

Creation of the Euro

- But implementation remained at national level
- The Council was empowered to make regulations for the surveillance of budgetary provisions and co-ordination of economic policies, including submitting annually a stability programme providing medium term objectives for a balanced budget and steps to be taken to achieve this
- The Council can issue recommendations and make them public but has no direct power to bring about its recommendations
- Eurozone states were also under an absolute obligation to avoid "excessive deficits" defined as 3% of gross domestic product (**GDP**) and government debt not to exceed 60% of GDP

Creation of the Euro

- But adherence to these targets proved difficult and the Council agreed to hold the excess deficit procedure “in abeyance” in 2003 when both Germany and France broke the rules

- The Commission even brought formal proceedings against the Council before the European Court of Justice for failing to enforce the Stability and Growth Pact and to bring sanctions against Germany and France

Creation of the Euro

- Article 118 of the EC Treaty provides:

  "The composition of the ECU basket shall not be changed…and shall be irrevocably fixed in accordance with Article 123(4)"

- The term 'Euro' was, therefore, a mere rebranding of the ECU

Creation of the Euro

- Article 123(4) required a unanimous vote of Eurozone States following a proposal from the Commission to irrevocably fix the conversion rates for each Member State and the substitution of the ECU for these currencies and which shall become: "… a currency in its own right"

Creation of the Euro

- Other provisions to note under the EC Treaty include:

  (i) neither the ECB nor central banks of Member States may grant overdraft or credit facilities to Community institutions or to central, regional or other government bodies or public authorities. So national central banks cannot finance their own Member States' deficits and these must be funded from third parties on commercial terms;

  (ii) the Community cannot assume the liabilities of Member States nor is it liable for commitments of central governments, regional, local or other public authorities – referred to as the "no bail out" clause. So Member States remain responsible for their own budgetary and fiscal position;

  (iii) Whilst Member States pool certain foreign currency assets as a result of monetary union they do not pool liabilities.

Creation of the Euro

- Fiscal policy largely remains a matter for each Member State with spending and taxation in particular not (generally) regulated by the Treaty but of course influenced by the overall deficit rules.

- European Central Bank (**ECB**) and the European System of Central Banks (**ESCB**) formed in 1999 when the Euro came into existence

- The ECB is an international organisation created by the EC Treaty

- Funded by subscriptions from Member State central banks and their foreign reserves. As such, its assets and liabilities are completely separate from those of the Community and is independent of the Community.

Creation of the Euro

- The ECB has the exclusive right to issue Euros. The ECB therefore became a new and independent source of money

- The ECB is governed through an Executive Board and a Governing Council. The latter is itself made up of the members of the Executive Board and representatives of each national central bank of the Eurozone. The Executive Board implements the policy determined by the Governing Council, usually through the ESCB.

Creation of the Euro

- The ESCB consists of the ECB itself and central banks of each Member State. It does not have separate legal identity

- The objective of the ESCB is to maintain price stability and low inflation and it holds and manages the foreign reserves of Member States

- The ESCB, like the ECB, is required to act independently of both Community institutions and national governments and is not required to consult with other EU institutions

Creation of the Euro

- National central banks, when operating foreign reserve operations act as agent of the ECB and all profits belong to the ECB.

Redenomination: the Relevant Legal Principles

- *Lex Monetae*
- Governing law
- Jurisdiction
- Currency of payment
- Placement of payment
- Location of entities
- Identity of the obligor
- Parties' contractual intention

Lex Monetae – "the law of the money"

- Independent states enjoy sovereignty over their own monetary systems

- Thus, a sovereign state can freely declare that its current currency is to be replaced by a new currency and declare monetary obligations are to be redenominated into the new currency at a stipulated exchange rate calculated by reference to its prior currency

- If a monetary obligation refers to a particular currency, the law of the country where that currency is used will determine what currency payment is to be made in, regardless of the governing law of the contract

Lex Monetae

- This is an English legal principle but is internationally recognised and has been followed by courts in multiple jurisdictions when considering currency changes introduced by independent states over the years

- As a result of the *lex monetae* principle, monetary obligations can never simply cease to exist but must be replaced by a new unit of account or currency

- This is critical as otherwise debt/other monetary obligations would be completely extinguished on the introduction of a new currency

- There will always, therefore, be a legal ‘link’ between the old and the new substituted currency – otherwise it would be impossible, domestically and internationally, to ‘revalue’ existing debt/contracts

Lex Monetae: Application

- Establish the legal territorial 'nexus' of the contract/ obligation
- Explicit: redenomination clause
- Implicit – consider:

  - Governing law
  - Location of obligor
  - Place of payment
- If all factors point to, for example, an exiting Member State, there is a rebuttable presumption that that country's currency law applies (and, therefore, Euro obligation can be redenominated into new local currency)

Governing Law

- If the contract is governed by an exiting Member State's law:
  - English courts will apply that law under Rome I Regulation
  - Unless that law is manifestly contrary to English public policy or prohibited pursuant to mandatory English law
    - E.g., the exit was unilateral and in breach of an EU Treaty
    - In which case, an English court will instead apply conflict of laws principles to determine governing law

Governing Law

- If the contract is governed by English law
- An exiting Member State's new currency law will not affect contractual obligations, subject to other relevant factors (e.g., jurisdiction and place of payment)

Jurisdiction

- If the contract's governing law is that of the exiting Member State
  - And local law redenominates existing monetary obligations from Euros into a new currency
- Assuming the exiting Member State remains in the E.U., under the Brussels I Regulation:
    - English/ EU Member States' courts will recognise court judgements in the exiting Member State
    - Unless manifestly against English / relevant EU Member State's public policy
    - E.g., if the exit was unilateral and illegal

Jurisdiction

- If the monetary obligation is governed by foreign law:
  - Exiting country cannot change via local currency law
- If not explicit in contract, courts determine jurisdiction

Currency of Payment

- What was the parties' contractual intention?
- Does the definition of the currency of the obligation point to the Euro or to the currency of the exiting state, from time to time?

The Definition of “Euros” – An Example

- ISDA 2000/2006 definition: “lawful currency of the member states of the European Union that adopt the single currency in accordance with the EC Treaty”
- Strong implication that Euro intended
- Redenomination unlikely

Currency of Payment

- If the definition of the currency is ambiguous, the court will look to other relevant factors, e.g.:
  - Place of payment
  - Issuer's intention

Place of Payment

- Relevant to ascertaining the parties' intended currency of payment
- Article 12(2) Rome I Regulation (**RIR**) provides that courts should have regard to the place of performance of a contractual obligation when considering the manner of performance and steps to take where performance is defective
- English law has a *rebuttable* presumption that currency is that of the place of payment
- But, if payment is to be made in an exiting Member State, an English court can give priority to that country's redenomination law under article 9(3) RIR

Place of Payment: Example

- No definition of currency in the contract
- Place of payment is in an exiting Member State
- There is a rebuttable presumption that the issuer intended the currency to be that of the exiting Member State from time to time
- Redenomination laws of that exiting Member State would, therefore, be recognised
- Conversion rate would be provided in the exiting Member State's law

Place of Payment: Example

- Place of payment outside exiting Member State or in multiple places
- Presumption does not come into play
- The court will have discretion to determine currency of payment based on other relevant factors

Place of Payment and Governing Law

Place of payment provision?	Governing law?	Redenomination?
Yes	Exiting Member State	Yes
Yes	Foreign law	Yes
No	Exiting Member State	Maybe
No	Foreign law	Maybe

Identity of the Obligor

- Sovereign
  - Presumption that currency is that of the sovereign
  - If the sovereign is an exiting Member State, the contract may therefore be redenominated
- Entity resident or incorporated in an exiting Member State
  - Redenomination under new currency law
- Less likely to recognise redenomination if there are multiple obligors

Enforcement

- Local court

  - Enforce in local currency under their currency law
  - Conversion at time of award/ given date
  - Insolvency conversion at time of filing

- English/ foreign court

  - Enforcement more likely in relevant foreign currency

Eurozone break-up: possible scenarios

- Complete
- Partial
- Legal
- Illegal

Partial, Legal Break-up

- Article 50 TFEU ("Lisbon Treaty") – right to withdraw from the EU

  - Agreement
  - Two years' notice

- Amend EU Treaties under Article 48 TEU

Partial, Legal Break-up

- Eurozone contracts redenominated under EU Directive
- English or Foreign court
  - Most likely apply *lex monetae* principle

Partial, Illegal Break-up

- No multilaterally agreed framework
- Exiting Member State courts enforce new currency law – redenominate into local currency
- English and Foreign courts: no redenomination – remain in euros

Partial Break-up

- Euro remains
- Possibility of split into “hard” and “soft” euro currencies

Complete break-up

- Euro ceases to exist
- ECB dissolved
- All Eurozone countries redenominate

  - National currencies
  - New currency unions: new currencies and central banks

Complete, Legal

- Contracts cannot be settled in Euros
- Redenomination → new national currencies

  - *Lex Monetae*
  - Impracticality
  - Commercial impossibility

- Replacement European single currency unit
- Reverse process for introduction of the Euro in January 1999

Possible Scenarios

	Partial Break-up Unilateral Exit	Multilateral Agreed Exit	Legal Complete Break-up	Illegal Complete Break-up
Obligations governed by local law	Euro remains - no redenomination (Insolvency = exception)	Euro remains (some redenomination under *lex monetae* and/or EU Directive	Redenomination under EU Directive into new national currencies or ECU-2	Redenomination as per local currency laws or apply conversion rates of ECU-2
Obligations governed by foreign law	Redenomination into new national currency (via local law, unless against public policy/laws of relevant foreign country)			

Documentary Implications

- Euro-denominated funds
- Service provider contracts
- ISDA/ other derivatives contracts

Contingency Plans

- Are they necessary?
  - “Thinking the unthinkable on a Eurozone break-up” (FT 27/11/11)
  - “Europe fails to reach the summit” (FT 11/12/11)

Contingency Plans

- Re-draft certain terms

  - E.g., references to EURIBOR-based interest rate
  - Definition of Euro

- Additional terms

  - Depends on governing law and contractual obligations
  - Mechanism to switch Euro denominated shares into alternative currency share class

Contingency Plans – Key Contractual Terms

- Timing of payments
- Price
- Indemnity provisions
- Termination events
- Definition of currency
- Place of payment

Contingency Plans: Points to Consider

- Terminate risky contracts
- Re-negotiate existing contracts
- Protective provisions
- Risk factors in prospectus/ marketing materials
- Credit risk management (hedging, diversification etc)
- Location of financial investments and bank accounts

The Draft Treaty

- "Fiscal compact"
- Third draft produced 10th January 2012
- Plan to agree before 29th January 2012 summit (which will cover measures for growth – not the Euro)
- Should be signed by the end of March

Lex Monetae in Practice

Example Scenario 1

- Two contracts governed by English law between an entity in Member State A and an English counterparty guaranteed by a bank in Member State A

- Member State A exits the Euro (but Euro continues to exist) and introduces a new currency at a rate of 4000 new units = 1 Euro (implied devaluation of 50% as ECU conversion rate was 1 Euro = 2000 units)

Lex Monetae in Practice

- Example Scenario 1
- A EUR 1m obligation effectively becomes a EUR 500,000 obligation
- Member State A entity defaults and English counterparty sues under guarantee
- 1 contract provides for payment in Sterling; the other in Euro
- 1 contract provides for payment in London; the other in Member State A

Lex Monetae in Practice

- Example Scenario 1
- In what currency are these obligations to be paid? This will depend on which country's monetary law applies
- Important not least as new currency may fluctuate against Euro, may be exchange controls imposed etc
- Actions could be brought in English or Member State A courts

Lex Monetae in Practice

- Example Scenario 1

- Member State A court decision will depend on exact terms of local law – e.g. do new currency laws make it mandatory to pay all Euro obligations in new currency or only those where debtor is from Member State A and/or only where the obligation is to be discharged in Member State A?

Lex Monetae in Practice

Example Scenario 1

- Safe to assume that Member State A courts will find payment must be made in Member State A new currency if payment was due by a local entity and in Member State A

Lex Monetae in Practice

- Example Scenario 1
- But if payment was due to be made in Euro in London and new local currency law only made local payments mandatory English law would be the proper law of the contract and English law would recognise the Euro as a continuing currency
- Thus even a Member State A court should find the guarantee had to be honoured in Euros

Lex Monetae in Practice

Example Scenario 1

- The Sterling contracts could be required to be honoured in new Member State A currency if payable in Member State A but in Sterling if payable in London

- The rule to be applied by local courts depends on the terms of the new local law – if it makes payment in local currency mandatory in all cases then this overrides governing law of contract and place of payment

Lex Monetae in Practice

- Example Scenario 1
- But if it makes payment in local currency mandatory only in limited circumstances – say local payment and local obligor – then local courts will only automatically require payment in those limited circumstances
- If outside these mandatory rules then normal contract interpretation will follow – governing law, place of payment, parties' intentions etc

Lex Monetae in Practice

- Example Scenario 1
- If the same case was brought in the English courts would the result change?
- Although the English courts would recognise the new Member State A currency as validly existing, it does not follow that they would automatically find payment should be made in that new currency, even where payment is to be made locally and debtor is from Member State A

Lex Monetae in Practice

- Example Scenario 1
- The English courts would have to decide which *lex monetae* applied - Member State A or the remainder of the Eurozone as the Euro continues in existence
- This is a matter of contractual interpretation and the English courts would apply English law to determine what the parties intended
- Did the parties intend to contract by reference to the currency of Member State A from time to time?

Lex Monetae in Practice

- Example Scenario 1
- Where the obligation is expressed in Euros and payment in London, the court should find it continues to be a Euro obligation
- Where payment is in Member State A, an English court may find that payment should be in the local currency, depending on all the facts

Lex Monetae in Practice

- Example Scenario 1
- If Member State A left without consent would it make a difference?
- Yes, in the case of English court decisions at least
- An illegal departure would make English courts likely to disregard local law in all cases as it would be incompatible with English public policy for an English court to recognise the illegal act of Member State A

Lex Monetae in Practice

- Example Scenario 2
- Same facts as Scenario 1 but orderly abandonment of the Euro
- Member State A courts likely to arrive at same decisions as in Scenario 1
- But English courts cannot follow *lex monetae* of Eurozone in this case as it ceases to exist. So would need to find other criteria to decide.

Lex Monetae in Practice

Example Scenario 2

- Place of payment would imply Sterling even for Euro obligation but this may not be logical and would depend on all the facts
- E.g. if purpose of underlying contract was to hedge obligation of Member State A entity business in Member State B, new currency of Member State B could be the appropriate currency

Lex Monetae in Practice

- Example Scenario 3
- Disorderly breakdown of entire Eurozone – ‘Eurozone Black Wednesday’ or the ‘Revenge of the Brits’?
- Again local courts would come to same decision as in Scenario 1 above
- English courts could theoretically disregard all local *lex monetae* on ground entire break up was contrary to EC Treaty etc but perhaps more likely to follow Scenario 2

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