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Eurofit

How to get in shape to deal with Eurozone risks

July 2015

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Introduction

On 30 June 2015 Greece failed to make a debt repayment of €1.5bn to the IMF, becoming the first developed economy to miss a repayment and plunging it further into economic crisis. A further repayment of €3.5bn is due to the European Central Bank on 20 July. Greece's decision on 5 July to reject the terms of the international bailout, after five years and around €240bn of European bailouts, may well result in its exit from the euro.

European leaders are calling for an emergency summit amid fears of contagion and for the euro's future. Although the Eurozone will likely survive the current crisis, it remains difficult to predict what it will look like in three months' time, let alone a year. Outside of Greece, other European member states are watching anxiously, some concerned they may end up in a similar situation. Until recently the idea that any member would withdraw or be expelled was dismissed as purely theoretical. Although the situation remains fluid, some economists are now warning: Brace for a Grexit – European Monetary Union exit is the most likely scenario.

It is to be hoped that there will be no further defaults and that the euro survives. But, were it to occur, the economic impact of a Greek exit is likely to be significant, raising fears it will further set back the recovery of the Eurozone economy. Businesses with any exposure to the euro are asking themselves what actions they can or should take now to reduce the negative impact of the crisis, as well as putting in place contingency plans in case the crisis deepens.

CMS with its pan-European footprint is at the forefront of advising companies across all business sectors on how to deal with these issues. In this paper we discuss some of the critical issues that are troubling our clients and highlight some of the solutions that are being implemented. We also include practical checklists to help your business assess its business continuity risks and options for the worst case scenarios. In addition, we offer

- a briefing service on actions you can take now to reduce the risk of a negative impact
- a full audit and repair service for key contracts and financing arrangements
- assistance with your contingency planning as to actions to be implemented in selected damaging scenarios
- a full assessment of available jurisdictions if disputes emerge
- early case assessment to include recommendations for speedy resolution
- training to support the rollout of any changes to procedures that you need to revise or update
- bespoke presentations and briefing notes for your internal audiences.

If any of these issues are troubling you or if any of these services are of interest, please contact us to arrange a meeting to discuss how we might help.

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Contractual implications of a Eurozone fragmentation

Under the Treaty on the Functioning of the European Union, when joining the Eurozone, member states ceded control of their monetary policy to the European System of Central Banks. Accordingly, a member of the Economic and Monetary Union (EMU) who cannot meet its sovereign debt obligations cannot take any steps to improve its economy by depreciating its currency, changing its interest rates or increasing its money supply. Such a state can only use its fiscal policy to control government spending and taxation to strive to improve its economy. If the burden becomes too big then it may look to exit the Eurozone or be forced out.

How might the Eurozone fragment?

There is no specific mechanism for members of the EMU to withdraw. However, Article 50 of the Treaty on European Union contains provisions that would enable a member of the EU to withdraw from the EU as a whole, for its own constitutional requirements, without consent, by giving notice and negotiating an exit over two years. Although not explicitly stated, such a withdrawal from the EU would necessarily involve withdrawing from the EMU.

Given the benefits EU membership provides, such as free movement of goods and services, as well as subsidies, remaining within the EU would seem to be an obvious objective if it was available to a state wishing to regain control of its monetary policy. As the Treaties make no provision for this it could only be achieved through negotiation but some member states may not be prepared to tolerate this and/or may look for legal or economic ways to force the state out of the EU completely.

In summary, there are essentially four ways that the Eurozone might fragment with the EU remaining intact:

— one or more members of EMU give notice to withdraw from the EU exercising its Treaty rights to do so

— one or more members of EMU "unlawfully" cease to recognise the euro as their national currency while the remaining members of EMU maintain the

— euro as their only national currency

— all countries leave the EMU with each country adopting its own currency

— one or more members of EMU wishing to withdraw from the EMU enter into negotiations with the remaining members to agree an orderly exit.

— As well as the economic turmoil that will be caused by one or more member states exiting the Eurozone, parties to contracts will face practical difficulties in ascertaining how financial obligations under their contracts are to be settled when they are connected to an exiting member state.

— The fact that the euro has existed for over a decade and, until recently, has operated successfully, means that few contracts expressly envisage the euro ceasing to be the currency of one or more of the Eurozone member states.

— Given the many ways in which a Eurozone break-up may arise, it is impossible to give comprehensive guidance as to what effect such a break-up will have on existing contracts. This paper is intended to provide a general outline of possible break-up scenarios and their consequences from an English and EU law perspective.

Currency re-denomination

Whether an exit is orderly or disorderly the fallout will be significant. However, it is very difficult to predict because so much uncertainty surrounds what arrangements would be put in place and how the arrangements would be viewed by the national laws of each member state. In any event the departing state or states will need to implement their own domestic legislation to withdraw from the euro and to introduce a new currency. Here lies the nub of the issue for commerce. That legislation will have to nominate a new currency to replace the euro and fi x an exchange rate for that new currency.

Whether it attempts to fix the exchange rate through exchange control mechanisms or allows the price to float, it is widely predicted that the new currency will rapidly be devalued to its true worth.

All businesses trading in the Eurozone need to consider how this might impact their contracts. The heart of the problem is the risk that an obligation expressed or payable in euros will be 're-denominated' into the new currency. Similarly, security previously valued in euros may now be valued in a much weaker new currency. If the new currency rapidly devalues against the euro it could produce a dramatic loss for the collecting party and exchange controls may also hamper the ability to settle international contracts.

The precise scope of the new legislation could be a cause for concern. While it would be difficult to challenge a re-denomination in so far as it related purely to domestic contracts, depending on its actual scope it might be interpreted by its domestic courts to extend to any contract:

- governed by its domestic law
- where one of the parties is resident within their jurisdiction
- where the place for payment is within their jurisdiction
- where the lex monetae is its domestic law.

Lex Monetae – "euro" may not mean euro

The reference to a state's currency in a contract selects the law of that state to determine the identification of that currency. If that state changes its currency, the currency in the contract is also changed (unless the contract validly requires otherwise). The complication of the application of the lex monetae principle to the euro is that the euro is the currency of a number of states. To resolve this, one first needs to apply the governing law of the contract to determine according to its principles what was the lex monetae of the contract.

In the case of English law, an express reference to euro as the currency of the participating member states of EMU would require a debtor to continue to pay in euro if the Eurozone continued to exist, even if the debtor is domiciled in a state that has abandoned the euro.

However, if the parties have:

- defined euro as the currency of the exiting member state; or
- not given "euro" a definition or defined "euro" in a way that is unclear, but the contract expressly provides (or it can be implied) that that the place of payment is in the exiting member state,

then it is possible that an English court would find that payment was to be made in the new currency of the exiting member state using the exchange rate specified by the exiting member state's legislation, given that there is a rebuttable presumption in English law that the place of payment should determine the applicable currency.

If the euro completely ceased to exist, with all members of EMU establishing new currencies, the task of ascertaining what currency a debt is to be paid in will become more complicated given that the currency specified in the contract is not available, although the same principles of interpretation will apply. Given that the English courts are entitled to render judgments in sterling even where debts are expressed in a foreign currency, creditors may seek to have judgments given in sterling. However, there will not be a market exchange rate that can be applied at the time of judgment so it is unclear how the courts would calculate the amount of a sterling judgment if they agreed to grant judgment in sterling.

Re-denomination risk for lenders

Lenders risk borrowers becoming entitled to repay euro loans in a worthless new currency, or borrowers domiciled in an exiting member state being able to resist enforcement of a debt claim even if judgment in euro is given by foreign courts.

Lenders should examine documentation where borrowers or guarantors are located in a state that may leave the Eurozone. Ideally those documents will minimise the risk of re-denomination through the choice of law, choice of jurisdiction and place of payment being outside the relevant state(s) with euro being defined as the currency of the Eurozone (rather than the exiting member state). Lenders should check whether existing boiler plate clauses, such as material adverse change, currency indemnities and change of currency provisions will still apply.

In addition, even if the risk of an adverse re-denomination is small, lenders should consider seeking further assurance clauses or guarantor coverage clauses to require further security from obligors located outside the relevant member state. This would minimise the need to pursue enforcement action in the existing member state, which may be hampered by re-denomination legislation.

Lenders should also consider catering for the complete disappearance of the euro in new loan documentation, providing for a fall-back currency for repayments in the event of the euro ceasing to exist.

Debtor Risk
Repayment obligations in euros.
Debtors income is the new depreciating currency.
The cost of buying euros to repay becomes prohibitive.
Unable to meet payment obligations and become insolvent.

Creditor Risk
A loan was funded in euros.
Currency changed by local statute so obligations owed in new currency.
When the new currency depreciates the value of the debt falls.
The debt could end up valued at less than the cost of funding. Security may similarly devalue.

Financial health: your checklist
Where/who do you get financing from? What's their likely exposure?
Are there any bank accounts that should be moved to another state or bank?
In jurisdictions 'at risk' of withdrawing from the euro, the likelihood is that banks will close, perhaps for a few days, whilst they change currencies. Do you have interim options available to you e.g. alternative means of paying local staff?
Exposure to banks/level of deposits in EU member states – what happens if the state imposes a restriction on withdrawals?
What is your cash sweep policy?
What is your exposure to investment in bonds of EU member states?
Does your business/do your suppliers currently benefit from EU-related subsidies or State Aid? What would happen to your (or their) business model if these subsidies or aid are withdrawn?
Are you monitoring customer/key supplier/agent credit ratings or other financial covenant strength indicators?
Have you considered customer payment difficulties or the likelihood of difficulties arising in relation to contract renewals or extensions?
Do you have a communications plan prepared to address regulatory/stakeholder reporting requirements?
Are your financial systems (billing/payment) capable of a rapid switch to a new currency?
What cash flow risk are you exposed to through your/your supplier's/customer's/trading partner's factoring agreements e.g. if a lender changes its risk exposure/appetite for particular jurisdictions?

Business continuity considerations
What is required to meet your regulatory and corporate governance obligations?
Analyse supply chain (multiple tiers): — Solvency risks – who might go out of business? — Dual or multi source opportunities / supply from outside Eurozone?
Contingency plan in the event a key supplier fails to honour its contract
Increase inventories of business critical components
Audit contracts for vulnerabilities
Update IP/software escrow
Update business continuity and disaster recovery plans
Review exit arrangements and plans
Review security of physical assets and staff (in event of social / political unrest)

Re-negotiating commercial contracts

In times of economic adversity, contracting parties regularly aim for the amendment or termination of agreements based on "unforeseen circumstances" – particularly if the relevant boilerplate terms are broadly drafted. The amendment or termination of contracts can be mutually beneficial, but it may equally have an adverse impact on one of the parties. Even if contracts are not frustrated by the withdrawal of countries from the euro or EU, debts payable under the contract may have to be re-denominated to the new national currency. Anticipating the risk of loss and checking which jurisdiction will govern any disagreements will be crucial.

In an ideal world, a contract would cater for all eventualities, whether or not EMU survives. Ideally another payment currency would be used. If this is not feasible, the contract should provide for payment in "euro" defined as the currency of members of EMU rather than as the currency of a member state. The place of payment should be a non-EMU state to avoid any presumption that, if the euro ceases to be the currency of an exiting member state, the new currency of that exiting member state is the intended currency of payment.

In order to cater for the euro ceasing to exist entirely, parties to contracts may provide for the payment currency to automatically convert to a more stable currency on a specific date. If this conversion is provided for, parties will need to consider when conversion will occur and what exchange rate should be used. As a backstop, a gross-up provision could be inserted to provide that, if any law compels the debtor to pay in the currency of an exiting member state, the amount paid will reflect the euro debt that would have been payable at a market exchange rate rather than any government specified exchange rate. Ideally any rate of exchange will be specified by the creditor.

Ultimately exchange controls may render any contractual provisions irrelevant since debtors in existing member states will be prohibited from paying in any currencies other than the new currency of the exiting member state.

Where possible, creditors should look to enhance credit support from entities outside of an exiting member state. This could include guarantees and security from affiliates, or letters of credit or guarantees from financial institutions.

Contract health: your checklist

Businesses (particularly those where business continuity is a regulatory requirement, or where exposure may be more than negligible) should consider reviewing their international contracts to determine whether the contractual terms expose them to any unforeseen risk and, if so, to identify what actions can be taken to mitigate those risks.

The checklist below focuses on commercial contracts – different types of agreements (e.g. factoring or loans) will have additional provisions that should be considered. Dependent on the findings of the review it may be appropriate to seek to re-negotiate the contract or, if that option is not viable, termination may be a solution or a lever to secure a solution.

Clause	Comments
Re-denomination pricing/ currency conversion	How will lex monetae impact the contract if one contracting party's state changes its currency? Where are the parties incorporated? What is the payment location? How is "euro" defined in the contract? Is there a mechanism for converting the currency or setting conversion rates?
Local agreements under global frameworks	If a global framework is in place, have any services been called off/local agreements signed in relation to "at risk" states?
Local billing/payment arrangements	Is billing in different currencies at the local level possible/required?
Price increase mechanism	If based on an index, e.g. retail or commodity prices, which country is the basis of the index?
Minimum purchase requirements	Could a change or delay in orders etc. cause a party to default on its minimum purchase obligations?
Covenants	Could a change or delay in revenues/supply etc. cause either party to breach any covenants in the contract?
Change control procedure (particularly on a change in law)	Does the contract contain detailed mechanisms for varying its terms or underlying products/services? Is there a bespoke regime for changes in law? Would this cover a contracting party's state changing its currency? What rights/obligations will each party have in that situation?
Retention of title	Are the provisions enforceable/effective – e.g. how will access to products be secured in practice?
IP/software escrow	Is all business critical software protected by an appropriate escrow arrangement? Where (state) is the deposit? What are the release triggers? In practice can you ensure effective access? Are the deposits up to date?
Set-off rights	Are any expressed in the contract? Are they enforceable under applicable law? If yes, are they restricted to the contract or do they extend to all arrangements between the parties or their wider groups?
Shipping obligations/orders	What is the order pipeline? Can advance orders be managed (postponed or expedited)? How are they to be shipped? Where are they stored?
Capital expenditure obligations	What cap-ex obligations do the parties have? Can any be suspended, postponed or cancelled?
Supply chain management	What rights do you have to pre-approve, audit or require the replacement of sub-contractors? How many tiers of the supply chain does this run to? Do you have access to sufficient information to enable you to identify weak links in the supply chain?
Exclusivity	Are you tied in to sole sourcing or can you dual or multi-source?
Business continuity and disaster recovery	Are the clauses fit for purpose? Are the plans up to date and have they been tested? Do they need revision to reflect the possible impact of the loss of a sub-contractor in the supply chain, the potential impact of political or social unrest in an "at risk" state etc.? Can the supply of services be moved to another state?
Exit/termination assistance	Are the clauses fit for purpose? Are the exit plans up to date and have they been tested and costed? Have registers of personnel and assets been updated? If a key sub-contractor is not available to assist, how will the assistance be provided? Is it clear how you will secure access to key personnel, assets and data?

Clause	Comments
Security and access obligations	Are these sufficiently robust and fit for purpose? Do they cover premises, assets, stock, personnel and ICT systems wherever located (including during warehousing, storage and transit?). Do they cater for the potential impact of political/social unrest? Are any plans up to date and have they been tested?
Insurance	Are the heads/levels of cover appropriate and sufficient? Do you have evidence that the policies are in place?
Governance	How is the relationship being managed? Are there any local arrangements? Are the parties following any process/have appropriate representatives been appointed and any changes notified as required by the contract? Are information flows sufficient? Does the process need to be formalised or re-invigorated to establish clear lines of communication and regular open updates (i.e. to discuss political/social temperature, perceived risks, supply chain health, cash flow etc.). How will issues be escalated?
Jurisdiction and governing law	Is the jurisdiction exclusive/does it permit forum shopping? Which law governs the contract? With regards to frameworks is this the same for the global / master agreement and all call off/local agreements?
Dispute resolution	What is the process (e.g. escalation followed by mediation/arbitration/ litigation)? Is injunctive relief permitted? Does the process permit sufficient dialogue? Is it appropriate/does one party have a stronger position / more discretion than the other? Are there any local arrangements?
MAC and force majeure	Do contracts deal with civil/political unrest or changes in law (e.g. currency re-denomination)?
Step-in	Could it be enforced in practice - i.e. could you or a third party nominated by you actually step in and take control to recover the situation? Would there be any barriers to achieving this?
Financial distress and security	How extensive are the provisions – do they already apply? If not, what are the triggers? Will they provide sufficient protection in the short/medium/long term? Do they allow for the use of trust accounts or other mechanisms to safeguard capital and payments to the sub-contractors/supply chain?
Termination triggers	Consider non-payment for an extended period? Sub-standard performance, financial distress, insolvency, change of control, force majeure or material adverse change?
Compensation on termination	Consider inside / outside limits of liability? In what circumstances are these applicable?

Considering whether early termination is an option

To answer this question one needs to consider:

- Mistake
- Frustration
- Force majeure
- Early termination provisions
- Material adverse change

Each contract would have to be considered on its terms and in light of its governing law's approach to each of these issues.

As a matter of English law it seems most unlikely that the choice of currency could have been a mistake such that it entitles one of the parties to treat the contract as terminated. At best it might be used to argue that the contract be amended to correct the mistake. Similarly, while English law recognises that events beyond a party's control may frustrate a contract's performance and the contract will terminate when the frustrating event occurs, it seems unlikely that as a matter of English law a change from euro to a new currency will be sufficiently fundamental to frustrate the contract and result in its termination.

Force majeure or material adverse change provisions could be triggered by a change in currency, if the clauses were drafted with this in mind. While this would have the benefit of enabling the termination of the contract, a creditor would still face a risk of re-denomination in recovering outstanding amounts due under the contract.

Choice of law and forum shopping

If an English court accepts jurisdiction over a dispute which is governed by the law of an exiting state, the English court would be expected to apply that law to re-denominate euros into the new currency. However, if the exiting member state had breached EU law when exiting the EMU, then the English court could refuse to allow re-denomination on the basis that it would be contrary to English public policy to recognise a law based on a breach of other legal obligations.

Further, notwithstanding an express choice of law in a contract, the Rome I Regulation (593/2008) which governs the choice of law in contracts between EU member states provides that a member state's courts may have the right to give effect to "overriding mandatory provisions" of local law irrespective of an express choice of law. Accordingly, if an exiting member state's court heard a dispute governed by English law, where English law required that payment was to be made in euros, the court could nevertheless enforce its local "overriding mandatory provisions" converting the payment into the new local currency.

If there is a real or perceived risk of an adverse decision in the domestic courts of an exiting state, swift action to secure a jurisdiction more favourable to one's interests may be well advised.

One impact of the Rome I Regulation is that the courts of an exiting member state will be bound to give effect to choices of law and jurisdiction in most commercial contracts if that Regulation still applies. If an exiting member state chooses to exit the EU entirely it may legislate to revoke the Regulation, meaning that parallel court proceedings may arise in the exiting member state and the jurisdiction specified in the contract.

Even if a jurisdiction is specified, it may have been specified on a non-exclusive basis, enabling parties to "forum shop" to find the courts that will offer the most assistance to their position. In terms of choice of law and jurisdiction, a creditor is likely to be in the best position if the parties to the relevant contract have chosen the governing law of a member state that is not the exiting member state, and have selected the courts of the jurisdiction of that governing law to hear any disputes.

Recognition and enforcement of judgments

Some creditors will benefit from security over assets located in, or guarantees from persons domiciled in, jurisdictions other than that of the exiting member state. If enforcement of those guarantees and security is sufficient to discharge the relevant debt, there will be no need to take enforcement action against the debtor in the exiting member state. However, if the creditor's only option is to enforce the judgment in the exiting member state, it may be that it is impossible to have that judgment enforced in the exiting member state in euros.

While the Brussels Regulation generally requires courts in an EU member state to give effect to judgments of the courts of other EU member states, such recognition is not required where it would be contrary to public policy of the state where the judgment is being enforced. Therefore, depending on the legislation passed by the exiting member state, that state's courts may refuse to enforce foreign judgments on grounds of public policy, or require payment to be made in the new local currency at the officially prescribed rate of conversion. If the exiting member state has left the EU entirely, claimants would need to consider whether it is possible to rely on historic conventions or treaties to have a judgment enforced even though they will have been superseded by the Brussels Regulation.

Similar considerations will apply if a party is attempting to enforce a judgment given by the courts of an exiting member state in another EU member state.

Legal Risk
A foreign creditor obtains judgment from the English court expressed in Euros. They seek to enforce against the debtor or debtor's assets in Greece.
The Greek court would have been bound to recognise the judgment under the Brussels Regulation (44/2001).
However, it may no longer be obliged to do so if enforcement would contradict the new Greek domestic law enacted to introduce the new currency.

It is worth bearing in mind that a debtor in the exiting member state is likely to have had all of its domestic holdings of euro converted into a new currency that may be rapidly depreciating in value. The debtor may no longer be able to pay international creditors because of exchange controls or because it has insufficient financial resources to meet debts denominated in foreign currencies. Creditors will need to assess whether the cost of obtaining a judgment in euro (or another existing and stable currency) and pursuing enforcement in an exiting member state will outweigh any benefit if the debtor does not have the resources to meet a judgment or is prohibited from making any payment in the judgment currency.

Conclusion

The fluid nature of the Eurozone crisis and the lack of clarity as to how any break-up would be structured legally mean it is difficult to provide comprehensive generic advice as to likely outcomes. While we hope the above is a useful summary, CMS has offices across Europe that will be able to provide bespoke advice in respect of specific contracts, jurisdictions and counterparties.

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