

Consequences of a Eurozone Exit:

Corporate briefing



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The Hogan Lovells eurozone taskforce comprises a cross-practice and cross-border team of lawyers able to advise on the wide range of complex business and legal issues surrounding the Eurozone. Full details of our eurozone taskforce members can be found at: www.hoganlovells.com/eurozone

Introduction

Whilst we hope that continuing efforts to hold the eurozone together will succeed, there remains a real risk that one or more weaker Member States may be forced (or decide) to leave the eurozone. This briefing note considers various issues for businesses to consider in this context.

For the purposes of this briefing, we do not consider a full break-up of the euro and we assume that the euro will continue as a lawful currency. The effects highlighted in this briefing do not comprise an exhaustive list of all potential issues but highlight key commercial or legal issues.

What can businesses expect at a macro level?

If a Member State left the eurozone, the trading and financial landscape could change dramatically and such change is likely to happen with little or no advance warning. There is no established legal framework for withdrawal of a Member State from the euro and the withdrawal may, or may not, be accompanied by full withdrawal of the affected state from the European Union, which is a lengthy process. Upon a Member State leaving the eurozone (an "Affected State"):

- Currency and debt redenomination in the Affected State may lead to a rapid devaluation of the replacement currency;
- Capital controls may be imposed by the Affected State to protect it against capital flight;
- Enforcement against contracting parties in an Affected State may be challenging, given the expected increase in case volume and protective measures likely to be introduced by the Affected State;
- Certain businesses in the Affected State may face potential insolvency;
- Credit needs may be met by the central bank of the Affected State printing money, leading to inflation; and
- Credit availability within the eurozone will be further squeezed.

How could this affect businesses?

The departure of an Affected State from the eurozone and the resulting macro effects listed above could have wide-ranging consequences for businesses, including:

- Business disruption and significant managerial disruption;
- Systems, reporting and processing issues;
- An impact on capital adequacy;
- Consequences in respect of existing contractual arrangements and contracting strategy;
- An impact on loan agreements, bonds and derivative contracts;
- Trading issues with both suppliers and customers and supply chain disruption;
- Intra-group issues in respect of parent or subsidiary companies domiciled in an Affected State;
- Reduced financial strength of joint venture partners; and
- Increased transaction risks in M&A transactions and reduced deal certainty.

Impact on business structure, cash flow and trading operations

Contracting strategy

Businesses who trade in the eurozone could find their operations materially affected by the withdrawal of an Affected State and should consider conducting a review of all existing contractual arrangements and current contracting strategy as part of their general contingency planning.

It would also be worthwhile for businesses to review the terms of their business interruption insurance policies to clarify whether they are likely to be compensated for any disruption caused by the withdrawal of an Affected State.

We set out below a checklist of key issues to be considered when conducting a review of existing contracts and in developing or revising a contract strategy.

Checklist

- Is “euro” defined in your existing and new agreements and related documentation and, if so how? Ideally it would refer to the currency of EU Member States for the time being participating in economic and monetary union under the Treaty.
- What would be the effect on long term payment obligations (eg in a lease or supply agreement) governed by the local law of an Affected State if those obligations were redenominated from the euro into a replacement currency?
- Consider including express wording to apply a preferred outcome to any redenomination of euro transactions. Alternatively, would express termination rights be a better solution?
- Consider whether standard force majeure clauses may apply (or not apply), particularly to payment obligations.
- Should you be transacting in a currency other than the euro or entering into hedging contracts for payment arrangements?
- Consider whether you should review your credit management policies to address any potential increase in credit risk.
- What will be the impact on any European or global framework or centralised procurement arrangements, particularly where the relevant entity is based in an Affected State or predominantly engages in euro-based transactions?
- Consider whether there may be advantages to reviewing the existing supply chain to re-focus (to the extent practical) liabilities and expenses within, and assets and income away from, more vulnerable eurozone states.

Risk of redenomination of contractual payment obligations

An Affected State may take several actions upon withdrawing from the eurozone, including:

- announcing its withdrawal from the eurozone over a weekend or public holiday with no specific prior warning;
- introducing a new national currency and a fixed rate for mandatory, automatic conversion of euro obligations into obligations denominated in that new currency; and
- introducing exchange controls to avoid massive euro outflows from the Affected State which could otherwise occur.

One of the key impacts of the withdrawal of a Member State from the eurozone would be on agreements entered into with contracting parties in the Affected State.

Should any action be taken now to mitigate redenomination risk?

A flowchart is set out on page 7 to help businesses identify contracts which may be subject to redenomination risk.

Contracts governed by the laws of a potential Affected State have a clear risk of redenomination. It may be possible to exercise some control over the redenomination effect if this is expressly covered in the contract by:

- choosing a governing law and jurisdiction for your contracts in which outcomes may be more predictable, for example English law and the English courts;
- checking whether, and if so how, “euro” is defined. If there is no definition or the definition refers to the currency of the Affected State, amend the definition to clarify that the euro is the currency of EU Member States for the time being participating in economic and monetary union under the Treaty; and
- amending the agreement to ensure that the place of payment is outside the Affected State.

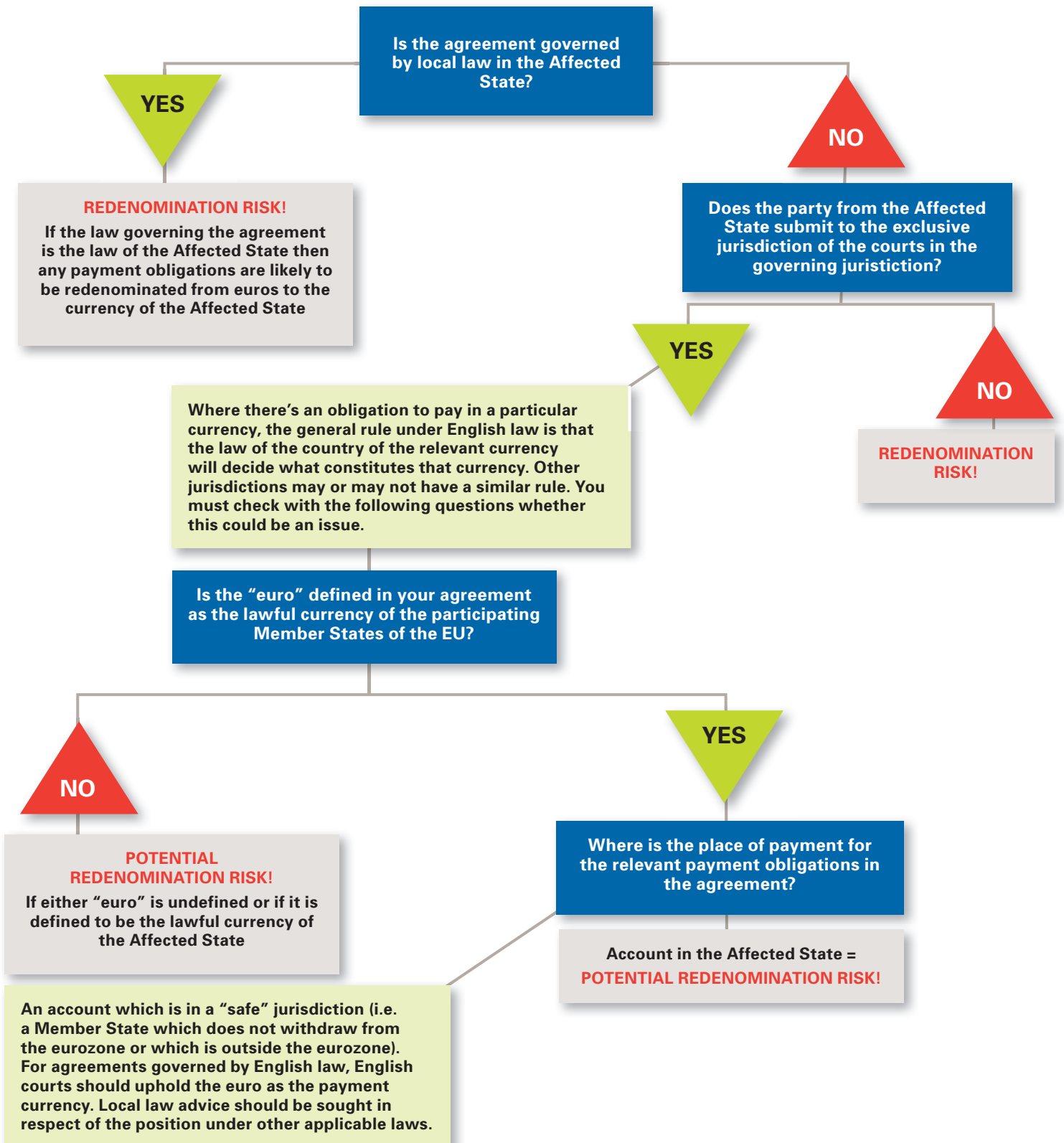
Preferred outcomes

Any review of existing contractual arrangements should focus on the company’s preferred outcome for each agreement in the event of such a withdrawal (eg termination, payment continuing in euros, payment in a replacement currency or payment in an existing currency other than the euro) and, if necessary, the amendment of the agreement to maximise the likelihood that the preferred outcome prevails.

In respect of new agreements (and the negotiation of any renewal or amendment of existing agreements), you should, depending on the nature of the connection of the agreement with the eurozone or a weak Member State, consider negotiating positions that provide greater protection in the case of a withdrawal of an Affected State.

In addition to the considerations outlined above (ie choice of governing law, definition of “euro” and place of payment), you may also want to consider including currency indemnities and other provisions expressly allocating risk of increased costs.

How to identify contracts at risk of redenomination



The 'ripple effect' – dealing with wider risk issues

The bigger picture

Most legal commentary has focused on redenomination risk; however, even where payment obligations in an agreement remain in euros, there could be other concerns:

- the economic turmoil caused to the relevant business by the euro withdrawal could have a severe impact on its cash flows. It is likely that an Affected State might try to impose exchange controls limiting payments out of the Affected State;
- if the other contracting party becomes insolvent, that insolvency would be governed by the laws of the company's centre of main interests. Where that is in the Affected State, then, if the payment obligations in the contract are unsecured, any payment out of the insolvency would be likely to be made under the laws of the Affected State and this is likely to mean that payment would be received in the new currency. This could result in a mismatch between the euro amount owed and the amount paid in the new currency; and
- if the contracting party's obligations in the agreement are secured by assets located in the Affected State or by a pledge over the shares or securities issued by a company incorporated in the Affected State, enforcement would be governed by the laws of the Affected State which could make enforcement challenging and complex.

Contingency planning

Businesses should carry out a risk assessment and carry out contingency planning such as:

- protecting staff in Affected States;
- making sure suitable and adequate insurance is in place, for example for business interruption;
- checking their disaster recovery plans; and
- testing systems and processes (such as accounting and ordering) to make sure they can cope with currency changes.

Businesses should also consider establishing a specific eurozone crisis committee so that an appropriate body with decision-making authority is in place and equipped to deal with eurozone issues if and when they arise. That committee should develop bespoke procedures to address issues that are specific to the eurozone crisis, including a tailored crisis reporting cascade.

Finance documents and banking

Depending on the nature and geographical location of a company's business, the withdrawal of an Affected State could have a material impact on its financing arrangements, banking and cash positions. This section provides a brief overview of potential issues related to finance agreements. For further detailed information on eurozone risks in respect of banking arrangements and finance documentation, please see the Hogan Lovells document "The Eurozone Crisis: Checklist of issues for finance documentation" which is available at: www.hoganlovells.com/eurozone.

Review of finance documents

Key financing documentation should be reviewed to clarify the consequences of an Affected State withdrawing from the eurozone.

Are there any contractual "events of default" which could apply? The occurrence of an event of default would not only allow acceleration and enforcement of security, but could also mean that a lender is entitled to draw-stop further requested utilisations. Individual loan agreements would need to be checked, but the most likely events of default for pre-existing loan agreements are non-payment default (if the obligor ceases to pay or pays in the wrong currency resulting in a shortfall) and material adverse change default (but this will depend on the drafting of the provision and the exact circumstances of the impact on the particular business of the Affected State's departure from the euro).

Cash positions

One issue to look out for is where a cash deposit in euros is held in a charged account located in an Affected State – lenders may require that cash deposit to be moved to a charged account in a "safe" Member State and it may be prudent in any event for a company to do so in order to try to avoid an event of default arising on withdrawal of an Affected State. The same point applies where a business in an Affected State has cash balances — amending the agreement to provide for regular cash repatriation to a "safe" Member State could also be considered.

Regardless of the requirements of their financing providers, businesses should consider repatriating cash balances to and/or opening accounts in safe Member States and in countries (and currencies) outside the Eurozone as a means of spreading risk.

Directors' duties and intra-group considerations

Directors of companies which are in "safe" Member States or which are outside the eurozone will need to consider carefully their duties and relevant corporate benefit considerations when providing loans and advances to group members located in weaker Member States and/or Affected States and should consider the potential impact of any such decisions in the context of the long term financial health of the company they serve and its wider stakeholders.

Group companies should also review existing intra-group arrangements to consider the redenomination risk to outstanding loan balances and in particular should consider the definition of "euro", the place of payment and any ability to vary the currency or location of payment.

Pension schemes

Companies should also have regard to the impact that could be had on any pension arrangements in their group. UK defined benefit schemes raise a particular concern as any impact on the funding status of such a scheme will have a direct impact on the financial position of the business. The pension scheme may well have investments in eurozone assets (eg shares, bonds or gilts) which would be impacted by disruption in the eurozone. It is also increasingly common for pension schemes to have entered into derivative instruments potentially with contracting parties located in the eurozone. Companies should consider discussing these issues with the trustees of their pension schemes and, in particular, ensuring that these issues have been considered.

The impact on mergers and acquisitions and joint ventures

Mergers and acquisitions

The increasing uncertainty surrounding the euro gives rise to certain areas of risk in M&A transactions and as a result companies should consider how they might try to address these risks by tightening up or incorporating new protections in the sale documentation, in particular:

- Contracting party financial strength

Naturally the value of any contractual agreement depends on the financial strength of the contracting parties to the agreement.

Whilst contracting party financial strength is not a new consideration that is unique to the eurozone crisis, this area of risk requires closer inspection in the current climate, given that it is difficult to predict how corporate contracting parties will be affected by any adverse eurozone event.

The point will be relevant both for sellers (in relation to cash consideration payable at completion where there is a delay between signing and completion) and for buyers (in relation to the buyer protections in the sale documentation – eg warranties and indemnities).

Where the risks associated with a particular contracting party appear unacceptable, there are well trodden paths to hedging the exposure, including:

- a group parent guarantee (where the relevant contracting party is a weaker subsidiary);
- a bank guarantee;
- the deposit of cash into escrow; and
- warranty and indemnity insurance.

- Conditionality – Material adverse change

In circumstances where completion of a deal is subject to conditions precedent eg regulatory, competition or shareholder consents, the consequences of a Member State's withdrawal from the euro (with or without a default) or worse still, some form of fragmentation of the eurozone, is likely to have severe repercussions on all businesses throughout the EU and, most likely, far wider. Such repercussions may undermine the commercial rationale for deals which have then been committed to and not yet completed. Any committed acquisition financing may also be put at risk.

The wording of Material Adverse Change clauses varies widely and the parties to a sale contract will need carefully to review the clause to ensure that the clause properly captures the kind of adverse Eurozone event following which they would want to have the right to back out and that any financing "outs" in their financing arrangements are accurately mirrored in the sale contract.

Sellers accepting listed paper as consideration may be equally concerned to ensure that transaction documents give them a walk-away right where the price of the share consideration goes down materially during the period before completion.

- Due diligence

When setting the scope for a due diligence review, buy-side companies will need to ensure that target contracts are analysed to assess vulnerabilities to adverse eurozone events, which will extend beyond the customary areas to include:

- any dependence on euro revenue streams generated from within weak Member States;
- event of default triggers in debt financing agreements;
- the scope of force majeure clauses in material trading contracts (see page 5); and
- material trade contracting party or service provider solvency risks.

The same considerations may apply equally to sellers on a securities exchange transaction in respect of the reverse due diligence they are likely to want to carry out on the Buyer.

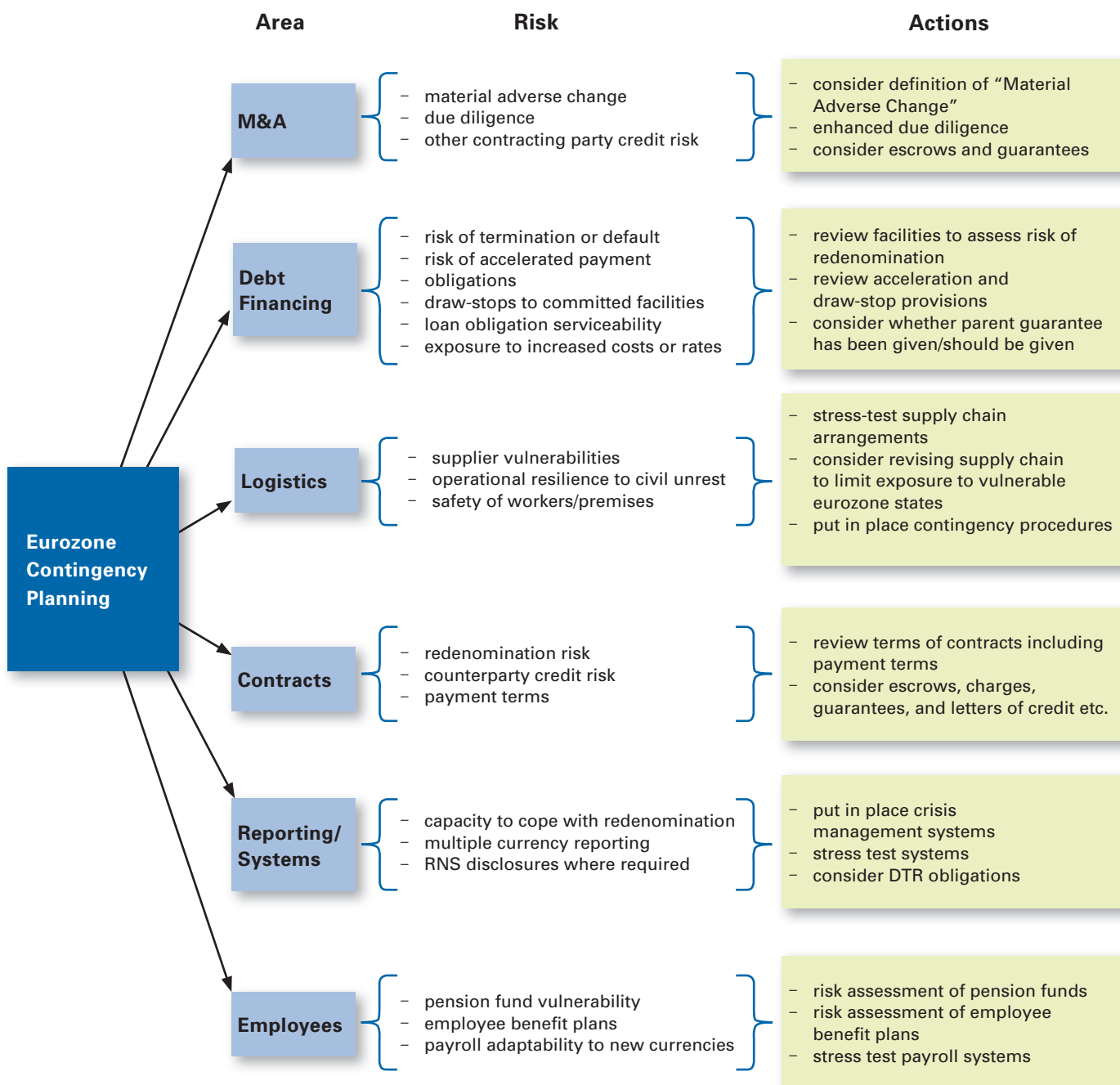
Joint ventures

In relation to new joint ventures, contracting party financial strength will be a key consideration when assessing a JV partner's ability to contribute start-up capital and also in terms of its capacity to fund a JV in the future and such assessment should include consideration of eurozone vulnerabilities.

In relation to existing joint ventures, companies should consider whether the joint venture is exposed to the insolvency of a joint venture partner located in an Affected State. Particularly where a joint venture partner located in a weaker Member State seconds

employees or provides premises to the joint venture or where the joint venture's operational assets are subject to charges in favour of such a joint venture partner (or ownership in the assets is retained by the joint venture partner), risk assessment and contingency planning should incorporate consideration of the vulnerability of the joint venture to the financial stability of the joint venture partner.

Indicative overview of key risks to be considered by businesses



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