The Eurozone Crisis:

Checklist of issues for finance documentation

May 2012

This checklist is for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation.

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Introduction

At this stage we do not know whether any Member States will leave the eurozone and, if this happens, how it will be effected. The legal consequences may vary, depending on whether departure is consensual or unilateral and whether a departing Member State leaves just the eurozone or the EU itself.

This checklist assumes that, regardless of the exact legal framework adopted at the time, the following things could happen. The departing Member State might:

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

This checklist does not consider the ramifications of a full euro break-up or the impact on the sovereign debt obligations of a departing Member State.

Impact on euro denominated loans if a Member State departs from the eurozone

Q1: Will obligations under the loan agreement remain denominated in euros?

Check each of the following points:

- Governing law and jurisdiction
  If the loan agreement is governed by the law of the departing Member State, the courts of that Member State are most likely to apply the new currency and exchange control laws, in which case euro denominated obligations under the loan agreement payable in the departing Member State would be treated by those courts as redenominated into obligations in the new currency at the prescribed conversion rate. Judgments of those courts could in theory be enforced throughout the EU under Brussels I Regulation (Council Regulation (EC) 44/2001), although in practice an affected party might seek to rely on Article 34 of the Regulation, which allows a party to resist enforcement on the ground that it is "manifestly contrary to public policy" in the Member State where enforcement is to take place. This would arguably be the case where, for example, the new currency had been introduced in breach of EU law.

  If the loan agreement is governed by English law, then, subject to our comments below, the English courts would be expected to apply the lex monetae principle.

  Lex monetae: Where obligations in a contract are expressed in a particular currency, the general rule is that the law of the country of that currency will decide what constitutes its lawful currency at the time of payment. The lex monetae of the euro is the EU legislation which introduced the single currency as part of economic and monetary union. If it is clear that references to "euro" in the loan agreement are to the euro as adopted by Member States participating in the single currency from time to time, then the courts should rule that references to the euro would be treated as such and not construed as meaning the new currency of the departing Member State.

  The courts would consider not only how the euro is defined but also the place of payment and any other relevant contractual provisions.

- How the "euro" is defined for the purpose of the loan agreement
  In many agreements, the term "euro" is undefined. This may be unhelpful but the omission is not fatal in itself. If the "euro" were defined in such a way as to be construed as being the currency of the departing Member State from time to time, this could give rise to a problem for the reasons explained above.

  The most favourable definition is one which makes it clear that the euro means the single currency adopted by Member States in accordance with the EU legislation on economic and monetary union.

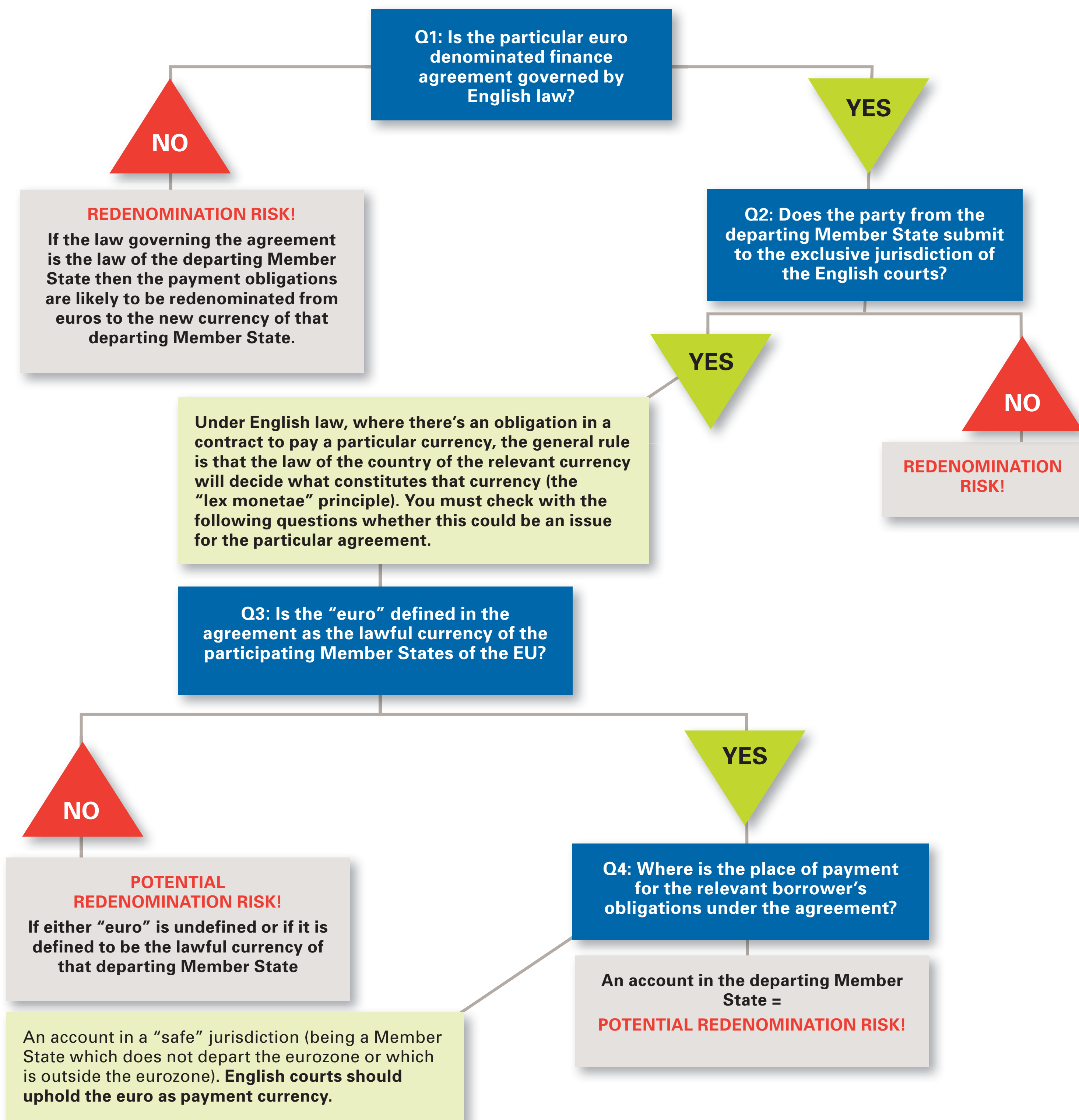
- Place of payment
  The place of payment is important for two reasons. First, the choice of law in a contract may be overridden, under the Rome I Regulation[1], by mandatory rules of the place of performance insofar as those mandatory rules render performance of the contract unlawful. Secondly, the Regulation requires the governing law of a contract to have regard to the law of the country in which performance takes place when determining the manner of performance.

- Change of currency provisions (if any)
  In new transactions, it is not essential to include a specific clause stating what the parties intend to happen if a Member State were to depart from the eurozone, provided that the governing law of the agreement is that of a jurisdiction other than the departing Member State, the courts of that jurisdiction have exclusive jurisdiction to hear a dispute, the euro is defined appropriately, and the place of payment is outside the departing Member State. However, there may be no harm in including such a specific clause where appropriate in new documentation.

The above considerations are summarised in this flow chart.

[1] Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I), articles 9(3) and 12(2).

Is my finance agreement at risk of redenomination?



Q2: What happens if a lender acts through an office in a departing Member State and the loan agreement requires it to lend in euros?

The answer to this question involves the same analysis as explained in Q1 above.

Whilst each individual loan agreement would need to be checked, the following issues might arise if a lender from a departing Member State ceased to be able to comply with its commitments to make euro loans available due to new legislation of that Member State:

- Its failure to pay at all could well be a breach of contract, depending on any market disruption protection for the benefit of lenders in the particular loan agreement. Most syndicated loan agreements provide that lenders are severally liable to lend, so that the borrower would be left short of funds with no recourse to the other lenders. The borrower could have a breach of contract claim but pursuing this might be time consuming and expensive.
- If an affected lender were to make payment in the new domestic currency of the departing Member State and not in euros, it would be necessary to check the contract to see if there would be a breach of contract through failure to pay in the required contractual currency (it is likely that there would be).
- If the loan agreement contains LMA style defaulting lender provisions, it is necessary to check whether the lender would fall within the definition of a "Defaulting Lender". It would be relevant to consider whether the lender's non-payment was a "repudiation" of the contract and whether a "Disruption Event" had occurred in the particular circumstances. If the defaulting lender provisions do apply, then the borrower might be able to:
  - cease to pay a commitment fee on undrawn facilities of the Defaulting Lender (while it remains a Defaulting Lender)
  - cancel any undrawn facilities which the Defaulting Lender was to provide
  - replace the Defaulting Lender by requiring it to transfer all of its rights and obligations to a replacement lender.
- If it had become illegal for a lender to perform any of its obligations under the loan agreement (or to fund, issue or maintain its participation in any utilisation), the borrower might be required to repay that lender in full under the illegality clause.

Q3: Could the lenders demand repayment?

Political and commercial considerations aside, demand for repayment could be made if a facility was uncommitted or, if it was committed, an event of default had occurred under the terms of the particular loan agreement.

In the short term, relevant events of default might include:

- breach of representation (e.g. if it were no longer possible for the borrower to pay in euros or if exchange control consent had become necessary to enable the borrower to do so)
- the occurrence of a "material adverse change" default if economic and financial circumstances had a sufficiently serious impact on the borrower.

There might be a specific event of default which could be triggered on eurozone exit, although this is unlikely except in the most recent transactions.

In the medium term, relevant events of default might include:

- payment default as a result of failure to pay in euros (or to pay at all)
- breach of financial covenants.

Q4: Are the lenders generally obliged to lend further money under the loan agreement?

Political and commercial considerations aside, a lender would not be obliged to make further advances if a facility was uncommitted or, if it was committed, a draw-stop event had occurred.

Draw-stop events usually include the occurrence of a Default (i.e. an event of default or a potential event of default), failure to satisfy conditions precedent, and failure to comply with the representations and warranties at the date of drawdown.

It is also possible that a market disruption provision might enable lenders to refuse to lend on the terms of the particular loan agreement.

The LMA "change of currency" clause provides that, if a change of currency of any country occurs, the loan agreement can be amended to comply with any generally accepted conventions and market practice in the relevant interbank market and otherwise to reflect the change of currency (the facility agent is typically required to act reasonably and after consultation with the borrower in making such amendments). It is difficult to see how this provision could be applied if a Member State were to withdraw from the euro and change its national currency but the euro were to remain the lawful currency of other Member States.

Q5: Can the lenders claim increased costs in continuing to provide the facilities?

Check:

- How would the **interest rate** be calculated if the loan had been redenominated into the new currency in place of euro payments? The contract would require clarification by the parties unless a successor rate could be implied.
- Might a **market disruption event** have occurred under the terms of a particular loan agreement by virtue of lenders experiencing funding difficulties? If so, the borrower could become obliged to match the lenders' actual cost of funds.
- Might the **increased costs** clause be triggered? This would depend on the actual wording and on the particular circumstances at the time, but lenders could seek to argue that receipt of payment in the new currency instead of euros would trigger the provisions entitling them to claim additional payments.
- Will affected assets still satisfy the **eligibility criteria** for collateral acceptable to the Central Bank facilities, payments and settlements systems? In order to be eligible as collateral for Eurosystem credit operations, assets must comply with various criteria, e.g. the currency of the assets must be the euro.

Q6: If exchange controls are imposed, what is the risk that the loan agreement will become an exchange contract?

The significance of a loan becoming an "exchange contract" is that it becomes unenforceable if one of the parties involved becomes subject to exchange controls imposed by their country, if that country is an IMF member. The IMF has 188 members so most countries are IMF members.

The IMF requires states which are members of the IMF to enforce each other's exchange controls when imposed consistently with the IMF Articles of Agreement.

Article 2(b) of the IMF Articles of Agreement states that:

"Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."

As such, the imposition of exchange controls could result in a finance agreement governed by the laws of a jurisdiction other than the departing Member State becoming unenforceable if performance would be in breach of those exchange controls and the contract is an "exchange contract".

IMF members have considerable control over this risk, however, because each jurisdiction has discretion over what it classifies as an "exchange contract". England, Germany and the US have adopted a narrow interpretation, so that only contracts which entail the exchange of one currency for another constitute exchange contracts. In contrast, France and the Netherlands have interpreted exchange contracts to mean contracts that have as their essential nature an exchange of goods or services that impacts foreign exchange reserves available in that country, which is considered a very broad interpretation.

In general, it is thought highly unlikely that a euro denominated credit facility governed by English law would be an "exchange contract" because the concept is currently interpreted so narrowly by the English courts. There may be less clarity in relation to a multi-currency credit facility and in relation to other types of finance agreements and derivatives. Specific advice would be needed, on a case by case basis, for different types of finance transactions and on a jurisdiction by jurisdiction basis.

If exchange controls were imposed by a departing Member State unilaterally, the extent to which these would be recognised outside that Member State might depend on their legality or otherwise under EU law. The same would apply even within the departing Member State, if it remained part of the EU.

Recommended action at this stage

- Carry out due diligence to identify loans and financial transactions at risk. Many lenders may have already completed this exercise.
- Revisit those deals at risk:
  - Can cash be repatriated out of the affected Member State at this stage? This may be particularly useful where security packages include cash collateral currently held in an account situated in a Member State at risk.
  - Do you need to change the definition of "euro" to clarify that it means the euro of Member States who continue to participate in the single currency (for the reasons given in Q1 above)?
  - Change the place of payment under the loan agreement to a financial centre outside the affected Member State. The loan agreement might not require amendment to do this. For instance, the LMA standard form loan agreement provides that the place of payment in relation to euro is "a principal financial centre in a Participating Member State or London with such bank as the Agent specifies". This means that it would be open to the facility agent simply to specify if necessary that the place for future payment will be a place outside a Member State at risk.
  - For both new and existing deals, consider adding a specific event of default which would apply on a euro departure (whilst this will not avoid risks, it may enable lenders to take prompt action if the need arises).

Impact on bond documentation if a Member State departs from the eurozone

Will obligations under bond documentation remain denominated in euros?

Governing law and jurisdiction clauses
The analysis set out in Q1 regarding governing law and jurisdiction will also apply to bond documentation. Usually in eurobond issues, the governing law is English law and the issuer would submit to the exclusive jurisdiction of the English courts for the benefit of the Trustee (if any) and the noteholders. However, in respect of domestic bond issues, the governing law is likely to be the local governing law.

How is "euro" defined in your bond documentation?
Typically in EMTN documentation there is no definition of "euro", in which case, as discussed above, it may be prudent to insert a definition which makes it clear that the euro is the single currency of the EU Member States in accordance with the EU legislation on economic and monetary union.

Place of payment
In respect of bonds which are held in global form and settled into the clearing systems, the place of payment will usually be the clearing systems, namely Euroclear Bank SA/NV or Clearstream Banking, S.A.

Are there any other provisions that might be affected by any redenomination?

Similar to the analysis set out in Q2 above, if an issuer from a departing Member State can no longer comply with its commitments to make payments in euros but attempts to make a payment in the new domestic currency, there could be a payment event of default. Other provisions which also may be affected include the definition of bank holidays (which will impact on the definition of local business day for notices where the departing Member State declares additional bank holidays to assist with the redenomination process).

Recommended action at this stage

If you are entering into new eurobond documentation involving a party from a potential departing Member State, it would be prudent to choose a suitable governing law, such as English law and submission to the exclusive jurisdiction of the English courts, whilst also ensuring that you have an appropriate definition of "euro" as discussed above and that the place of payment is outside the departing Member State.

Impact on derivative transactions if a Member State departs from the eurozone

Will derivative transactions entered into under the 1992 or 2002 ISDA Master Agreements remain denominated in euros?

Governing law and jurisdiction
The analysis set out in Q1 regarding governing law and jurisdiction will also apply to derivative transactions that have been entered into under the 1992 or 2002 ISDA Master Agreements with a counterparty in a departing Member State and where payments are expressed to be made in euros.

You should establish whether you have entered into any derivative transactions that might be at risk of redenomination and locate the relevant documentation, establishing what elections have been made and in particular identifying any documentation governed by the law of the potential departing Member State, for which a redenomination risk will clearly apply.

How is "euro" defined in your documentation?
As mentioned in Q1, it is important to check whether and, if so, how "euro" is defined in your documentation. Under the 2000 and 2006 ISDA Definitions the euro is defined as "the lawful currency of the states of the European Union that adopt the single currency in accordance with the EC Treaty". This definition should be helpful as it clearly refers to the euro as the currency unit of the European Union and not the currency of a particular Member State.

Place of payment
Given the importance of the place of payment as indicated in Q1, you may want to specify a place of payment outside the departing Member State. Under the 1992 and 2002 ISDA Master Agreements, the payee can select the place of payment by giving 5 local business days' notice to the other party, subject to the reasonable objection of the other party.

Will there be any other operational difficulties with the derivative transaction as a result of the redenomination?

Other provisions in the ISDA documentation that may be affected include the definition of bank holidays (which will impact on the definition of local business day for notices where the departing Member State declares additional bank holidays to assist with the redenomination process), the ability to net payments and if appropriate floating rate options (e.g. the definition of EURIBOR).

Are there any events of default that might be triggered?

Although the exit of a departing Member State would not in itself be an event of default or termination event under the 1992 and 2002 ISDA Master Agreements, it is likely that other termination events or events of default might soon follow. These could range from a simple failure to pay as a result of the counterparty not having access to euros to an illegality termination event caused by the departing Member State imposing exchange controls prohibiting companies from making payments in euros outside of that Member State.

What if the derivative is being used for hedging purposes?

If the derivative transaction was entered into to hedge another liability, it will be necessary to review the documentation for that liability to ensure it receives the same treatment as the derivative. If the underlying liability is redenominated whilst payment obligations under the derivative are not (or vice versa), the hedge would cease to be effective and a mismatch could occur.

If a derivative ceases to be an effective hedge for another liability, the holder of the derivative may be required to recognise that hedge in its accounts where it had not done so previously. This could give rise to a charge to tax or generate a tax loss, depending on the exact accounting treatment and the tax laws of the jurisdiction in which the holder is resident for tax purposes.

Recommended action at this stage

If you are entering into new derivative transactions involving a counterparty from a potential departing Member State, it would be worth choosing a suitable governing law, such as English law, and submission to the exclusive jurisdiction of the English courts. It also makes sense to ensure that the ISDA definition of "euro" is used. In addition, the place of payment should be outside the jurisdiction of the Member State which you are concerned about.

For existing transactions, consideration needs to be given as to whether amendments are made to reflect the concerns highlighted above.

Tax considerations

A lender, noteholder or holder of a derivative contract may be subject to tax in its jurisdiction of tax residence on foreign exchange movements in the value of its assets. A party may have no forex exposure on euro denominated assets on the basis that its accounts are denominated in euros, or because it has hedged against that currency risk. If the counterparty's Member State leaves the eurozone and its obligations become payable in the Member State's replacement currency, the party may be subject to tax because of forex movements in the replacement currency.

Sometimes sterling denominated loan notes which are held by UK resident individuals will include a euro conversion clause to ensure that they can be redeemed in a currency other than sterling. This is to ensure that the loan notes are not qualifying corporate bonds for UK tax purposes. If it becomes impossible to redeem the loan notes in euros because of exchange control requirements in the issuer's jurisdiction, this could call into question the effectiveness of the euro conversion clause. Using a dollar conversion clause (which tends to be more common in practice), instead of a euro conversion clause, should avoid this issue.

Issues where an obligor in a departing Member State becomes unable to comply with its obligations

What considerations would arise if a lender needs to enforce security created (1) by an obligor in a departing Member State or (2) over assets situated in a departing Member State or shares in a company incorporated in a departing Member State?

Wherever enforcement of security was dependent on the courts of a departing Member State, it is likely that the new currency and exchange control laws would be applied and, together with the legal upheaval generally, this might make proceedings difficult, time-consuming, costly and ultimately unproductive. Lenders might suffer a shortfall, both because the markets for the assets to be disposed of might be depressed, and because recoveries would be denominated in the new currency unless a purchaser could be found who was willing to pay in a different currency.

If an obligor in a departing Member State becomes insolvent

The legal consequences of the insolvency of an obligor would vary, depending on whether the relevant Member State had left just the eurozone or the EU itself.

If a Member State had left just the eurozone:

- Check the location of the centre of main interest (COMI) of the obligor. If the COMI was in a Member State other than the departing Member State, the main insolvency proceedings (which would still be governed by the EC Regulation on Insolvency Proceedings)[2] would be opened in that jurisdiction and not in the departing Member State.
- If COMI was in the departing Member State, the main proceedings would be opened in that departing Member State. In common with a number of European jurisdictions, the insolvency laws of the departing Member State might provide that a debt payable in a foreign currency must, on commencement of insolvency proceedings, be converted into the local currency at the rate of exchange prevailing at that time. If the currency of the departing Member State had depreciated following the insolvency of the obligor, lenders might be faced with losses not only caused by the insolvency of the obligor but also by the currency conversion.

If a Member State were to leave the EU completely, there is a risk that the Member State would no longer be a "Member State" for the purposes of the EC Regulation on Insolvency Proceedings, as the Regulation has direct effect in all Member States. The following consequences might arise:

- The concepts of COMI, main and secondary proceedings might no longer apply. Local insolvency laws would prevail, and might allow insolvency proceedings to be started against an obligor and for those insolvency proceedings to take precedence over main proceedings commenced elsewhere against that obligor even if the COMI of that obligor was outside the departing Member State.
- The courts of the departing Member State might refuse to recognise insolvency proceedings started elsewhere, or to assist insolvency representatives appointed in those proceedings.

Finally, the issue noted above regarding the conversion of a debt payable in a foreign currency would also apply if a Member State were to leave the EU completely.

[2] Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings.

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