How Costly Would a Euro Exit Be?

Contract Redenomination Challenges

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Introduction

– Credentials – Disclaimer – Chatham House rule
– Contract redenomination challenges
– Multitude of interests
– No statutory framework
– Analysis depends on the particulars but some general points can be made
– Three years on
  – adjustments are happening
  – mitigating steps are being taken
  – where does this leave us?
Potential exit scenarios

– Legal mechanism for exit not straightforward
  – No express rights in EU Treaties to withdraw from eurozone
– Possible routes
  – Multilaterally agreed exit as amendment to Treaties or under Art 352
  – Withdrawal from EU as a whole under Art 50
  – Unilateral hostile withdrawal in violation of Treaties
Potential exit scenarios cont’d

– Various ways in which this may play out in practice, including
  – Lawful exit by individual Member State (MS) (weak or strong)
  – Unlawful exit by individual MS
  – Separation into blocs
  – Complete eurozone break-up
  – Road to madness – dealing in unknowns
Likely immediate consequences

– Much will depend on nature of exit but possibly
  – Redenomination of exiting MS’s currency – eg new Drachma
  – Imposition of exchange/capital controls by exiting MS
  – Possible unilateral rescheduling of sovereign debt
  – Corporate/bank insolvencies

– May also see pan-European legislation – form and timing heavily dependent on whether exit lawful or unlawful
Assumptions

- State withdraws from the eurozone (the Exiting Country)
- Exiting Country re-denominates into a new local currency at an artificial rate which overvalues such new local currency (the Redenomination).
- Capital and Exchange Controls are introduced in the Exiting Country
- The eurozone and the euro otherwise continue
- Unilateral exit in breach of EU Treaties and without pan-European supporting legislation (a Unilateral Exit)
- Consensual or orderly exit with pan-European supporting legislation (a Pan-European Supported Exit)
General principles of law - overview

– Extent to which contracts insulated from changes to law in exiting MS will depend on nature of exit and legislation
– Will also depend on
  – Governing law of contract
  – Jurisdiction
– Four key scenarios
  – Local law/local courts
  – Local law/external courts
  – External law/local courts
  – External law/external courts
General principles of law – overview cont’d

– Governing law analysis complicated by application of different regimes in different circs and lack of relevant case law
  – Rome I (contracts on or after 17 December 2009)
  – Rome Convention (Contracts (Applicable Law) Act 1990) (other contracts)
  – National law
  – IMF Agreement (as interpreted by national law)
Local law

– Local law and local courts (local law question BUT…)
  – Local courts likely to
    – Redenominate euro denominated contracts (if that is what legislation requires)
    – Apply capital/exchange control legislation – contracts unenforceable?
  – NO INSULATION

– Local law and external courts (partly local law question BUT…)
  – English courts may
    – Redenominate contracts/apply capital/exchange controls
    – BUT might rely on English public policy/mandatory laws to avoid this
      – Arts 21 and 9(2) Rome I
  – REAL RISK NO INSULATION
External law

- External law and local courts
  - Local courts may well still
    - Redenominate contracts if legislation is mandatory local law – Art 9(2) Rome I
    - Apply capital/exchange control legislation – Art 9(2) Rome I
  - STILL NO REAL INSULATION
- External law and external courts
  - Assume English law and English courts
  - Contracts largely insulated
  - BUT some important limits
External law and external courts – limits to insulation

- Law of place of performance of contract can come into play
  - Art 9(3) Rome I – “Effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be...performed, in so far as those overriding mandatory provisions render...performance...unlawful”
  - Scope/application unclear
  - If applied, could possibly render contract unenforceable
  - Position for older contracts more complex
- Art 12(2) Rome I – “In relation to the manner of performance...regard shall be had to the law of the country in which performance takes place”
  - Scope/application unclear BUT may cover payment currency
  - If applied, contract could possibly be redenominated but probably not unenforceable (without more)
- Risk for contracts where performance in vulnerable MS
External law and external courts – limits to insulation cont’d

– Law of **forum** can come into play
  – Art 9(2) Rome I – “Nothing in this Regulation shall restrict the application of the overriding mandatory provisions of the law of the forum”
  – Art 21 Rome I – “The application of a provision of the law of any country specified by this Regulation may be refused only if such application is manifestly incompatible with the public policy of the forum”
– May limit insulation if forum recognises what has happened in exiting MS
– BUT more likely a possible get out for external courts seeking to avoid having to apply local law
Post script – *Lex monetae*

– Common law principle
– Obligation to pay in particular currency is obligation to pay amount of debt in legal tender at time of payment under law of country in whose currency debt expressed
– Difficult to apply to common currencies
– If one MS exits and redenominates
  – Courts unlikely in *most* cases to construe reference to euro as reference to currency of exiting MS
  – BUT risk for contracts with particularly strong nexus to a vulnerable MS/unhelpful definition of “euro”
– If euro disappears altogether unclear which currency/currencies courts would look to
Capital and exchange controls

– Controls that regulate the way that domestic currency relates to international currency markets
– Imposed through national legislation
– Would be introduced by [weak] Exiting States
– May include eg fixed exchange rates, prohibitions on use of foreign currency within country, restrictions on ability to exchange domestic currency for foreign currency
– Precise effect will depend on scope and form of legislation
IMF Agreement

– Part of English law
– Most States worldwide are IMF members including all MSs
– Members obliged to avoid restrictions on current payments or transfers (quite widely defined) without Fund approval
– IMF Agreement includes provisions on recognition by members of other members’ exchange controls
Critical provision is Article VIII(2)(b)

“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…..”
IMF Agreement – Article VIII(2)(b)

– Exchange controls of IMF members *must* be recognised by courts of other members

– Contracts within definition of “exchange contracts” unenforceable, whatever governing law (note IMF guidance)

– Thus

  – Insulation provided by choice of external law destroyed
  – Ability of English (or other) courts to disregard exchange controls on public policy grounds severely limited
Litigation risks

– Parties may have various potential claims
– BUT even if you have a good claim, can you get hold of your money?
– Three key steps
  1. Obtaining judgment in relevant courts
  2. If judgment not satisfied, getting judgment recognised in State where debtor has assets
  3. Enforcing against debtor’s assets (and, if in exiting State, getting money out)
– Potential difficulties at each stage of process
– Particular issues for State counterparties – immunity
– Further issues where counterparty insolvent
What has the market been doing?

– Very difficult to advise or plan in abstract
– Impossible to achieve complete insulation
– Disinvestment & Depositor flight
– Insulating assets - Portfolios which can move, have moved
– Company Redomiciliation
– Matching assets and liabilities
– Documentation
– Redenomination risk is passed on to the weaker party
– BUT no major documentary changes from industry association or major players. Some banks have done detailed reviews and set up crisis plans, some have done only general assessments (and of course what the regulators have asked them to do).
Conclusion

– Certainty is elusive
– Rules remain undeveloped and untested
– There is large variance in the interpretation of these rules within the European Union]
– Market fragmentation will continue
– Contract rules do not promote certainty expected within a single currency area with the result that countries where contracts need to be more certain to attract new investment are seen to be more at risk
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Questions?

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