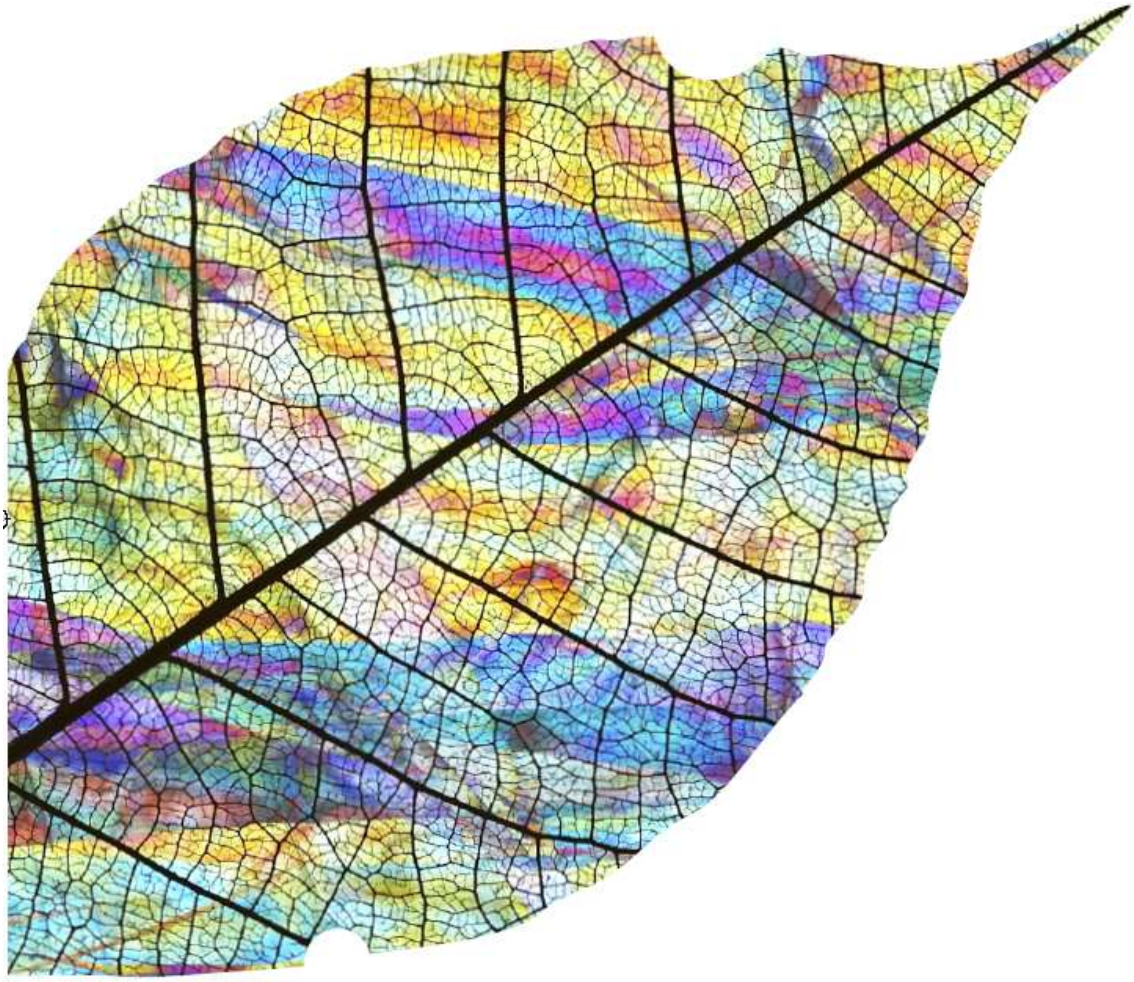
ALLEN & OVERY

A production of the Allen & Overy Global Law Intelligence Unit



Understanding withdrawals from a currency union: a short guide

20 April 2017

Understanding withdrawals from a currency union: a short guide

20 April 2017

1. What is this paper about?

This paper is intended as a response to questions in the market about the legal consequences of a hypothetical withdrawal from euro by a eurozone country. These questions are presumably inspired by concerns over political events in certain eurozone countries as well as on-going financial instability in others. Regardless of the reasons for which these questions are raised and without taking a view on the soundness or merit of these reasons, we thought it might be helpful for market participants to have this basic guide.

A withdrawal from the euro is a conversion of the currency of a member state of the eurozone, which is the euro, into an independent national currency. Accordingly this paper focuses on a change of currency, not an exit or withdrawal from the European Union, although a withdrawal from the eurozone might also imply an exit from the European Union (or a unilateral breach of its treaties) unless otherwise agreed.

This guide is based upon a paper we wrote in July 2012 called "*The euro: the ultimate crib (for those who have not been reading law firm memos about the break-up of currency unions)*". That paper dealt with the possibility of a Greek withdrawal from the euro because of the Greek debt restructuring in 2012, primarily to facilitate some contingency planning by those who regarded it then as a significant risk.

The Intelligence Unit does not make forecasts of the likelihood or otherwise of a euro breakup. Nevertheless, we think that the breakup of the euro or any withdrawals from the euro would be unwise. We doubt that 19 currencies are better than one, nor do we support the idea that 19 central banks should have the ability to manipulate money. The creation of the euro – the world's second biggest currency – was a bold and audacious feat. We believe that it would be very hard for any of the eurozone states to change their mind about this visionary achievement.

The views in this paper are the views of the Intelligence Unit and not necessarily those of the firm. Also, this is not legal advice.

2. Background

- The euro was established in 1999.
- The current members of the eurozone are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, the Slovak Republic, Slovenia and Spain.
- The following EU members are not members of the eurozone: Bulgaria, the Czech Republic, Croatia, Denmark, Hungary, Poland, Romania, Sweden and the UK. A number of countries, both inside and outside the EU are pegged to the euro and so the peg would be lost if there were a complete euro breakup.
- There is no express right of withdrawal from the eurozone in the EU treaties, but there is a procedure for withdrawal from the EU under Article 50 of the Treaty of the European Union. Withdrawal as a member state of the EU would probably carry with it a withdrawal from the eurozone by implication. Article 50, which is the Article applicable to Brexit, provides that a member state which decides to

withdraw shall notify the European Council and negotiate a withdrawal agreement. The European treaties cease to apply to the state in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification of the intention to withdraw. The withdrawal agreement requires only a qualified majority of the European Council but an extension of the two year period requires unanimity.

– A breakup of the euro could involve a currency conversion by a single state or a number of states. It could involve the emergence of two or more currency blocs or there could be a complete breakup of the euro. In this case, the single currency would be replaced by 19 new currencies. If a treaty did not provide for the weighting given to each new currency per euro, then this would have to be decided by the courts.
– Recent cases of currency union breakups include the USSR, Czechoslovakia and Yugoslavia. Other historical cases are legion. We have not counted precisely, but we expect that there have been more than 60 redenominations since 1950. Virtually all of these were driven by political breakups.
– A redenomination law might also be accompanied by exchange controls.

3. What should be the scope of contingency planning?

Firms must make their own assessment of the risks.

Contingency planning is like insurance. The premium you pay in terms of intensity of planning, application of resources, time and cost, and the scale of the reorganisation of the business depends upon your assessment of the risk.

You should decide which of the consequences listed below are possible and how they might impact on your business. If you think the risks are high, devote a team to the task. If you think the risks are infinitesimal, just sit back, do nothing and hope that it will all go away.

If you consider there are risks, consider the following:

– The redenomination of claims owed to you becomes payable in a new weak or inflated currency.
– Amounts you owe become payable in a stronger euro, increasing the liability.
– Payments owed to you by residents of the exiting country are blocked by exchange controls.
– Exports from the exiting country are cheaper if the buyer pays euro.
– Imports into the converting country are more expensive because of the weakened local currency.
– Residents, including local branches and subsidiaries, have to repatriate their foreign currency and foreign currency securities which are sold to the central bank at an unrealistic conversion rate.
– If the local currency inflates, interest rates are high.
– Costs and confusion in changing systems.
– There are extra currency risks for businesses which have to be hedged.
– The events could spark off events of default, draw-stops and contract terminations.
– There could be illegality and force majeure triggers in ISDA masters and other financial master agreements, and similar triggers in commercial contracts.
– A depreciating new currency and exchange controls could have an impact on financial statements. And therefore also on tax.
– Supply chains could be affected.
– For banks, access to capital and liquidity could be weakened.
– There could be mismatches between currencies, resulting in increased credit risks for affected businesses and banks.
– The redenomination might cause disruption and a loss of confidence.

Some commentators prophesy Armageddon scenarios: the instability results in more currency fragmentation, sovereign bankruptcies, collapses of banking systems and a complete breakdown of the eurozone in a disorderly way. The common currency disappears in a cloud of smoke. The disease creeps silently to the rest of the world and there is universal confusion. Darkness descends on the planet.

Then the sun comes up again and we plod through another day, as usual.

If you consider there is a perceptible risk, contingency planning should be considered by firms and others who:

- Have material exposures to companies and persons resident in a potential exiting country.
- Have material exposures to counterparties which themselves have exposures to companies and persons resident in exiting countries.

4. What would exiting laws say?

What do redenomination laws say?

Virtually everybody has a legal tender law: there are nearly 200 sovereign states and around 140 currencies.

Typical legal tender and redenomination laws provide:

- **Legal tender** The new currency is legal tender in the country for the payment of all public and private debts. This usually means that debtors can pay and creditors must accept the new currency in place of euros or other foreign currency. The law may apply to debtors resident in the country, to payments made in the country by creditors or debtors wherever they may be and also sometimes to nationals. Scope varies. See section 5 below for the recognition of this redenomination.
- **Conversion rate** The official rate of conversion is X. Black-market rates may spring up. Debtors and creditors can agree to pay in foreign currency, but this usual exception is often overridden by exchange controls.
- **Coin and notes** Coin and bank notes will be exchanged at banks.

What do exchange control regulations say?

Sometimes a state changing its currency may introduce exchange controls.

The intensity of exchange controls depends upon the risk of a sudden depreciation of the new currency of the exiting state and its credit in financial markets.

Exchange controls are more likely if there is widespread disruption and contagion caused, say, by the collapse of the euro.

Exchange controls aim to give the local central bank a monopoly of foreign currency. Exchange controls are the unpleasant end of redenomination.

The typical regulations are generally very detailed. For example, Argentina passed an Emergency Law in 2002 which was amended and supplemented by more than 130 further laws and regulations in the following two years. There were a number of amendments to the emergency legislation passed in Iceland. The regulations themselves may be accompanied by numerous governmental guidelines and discretions.

Exchange controls were common around the world from the late 1930s until 1980, except in the U.S. and Canada, and were a detailed field for specialists. Very complex exchange controls existed in most of Europe and still exist in such countries as India and China, amongst others.

Typical exchange controls provide:

- Residents of the country, and sometimes nationals wherever they may be, must not hold or lend or borrow foreign currency or foreign currency securities or pay debts in foreign currency.
- These residents may be prohibited from entering into derivative transactions with non-residents, at least if unrelated to the trading of goods and services so that, in effect, there is a prohibition on participating in futures markets or in foreign currency options.
- Foreign residents may not be permitted to hold local currency or local currency securities issued by local entities, so that the local currency is not convertible.
- Although investment into the country may not be restricted, divestment is usually prohibited by transferring capital out of the country in connection with the sale of direct investments, except sometimes for dividends and the like.
- Residents, and sometimes nationals, must turn over their holdings of foreign currency or foreign

currency securities to the central bank at a prescribed rate of exchange so that the central bank has a monopoly of foreign currency.

– The central bank grants exceptions, e.g. necessary trade payments or other current transactions. The granting of permissions is usually delegated to local banks.

In practice, if these controls are introduced, capital transactions, such as the repayment of the principal of loans and bonds, are much more tightly controlled than current transactions such as essential imports.

Exchange controls are despotic. If you cannot move your money, you cannot move.

Capital controls and controls on payments are generally not permitted under the EU treaties subject to public policy and public security exceptions.

Generally, the IMF agreement allows capital controls, but IMF approval may be required for exchange controls on current transactions, both of which are defined. Some years ago, Iceland received approval, but the Ukraine did not.

In both cases, the sanctions applied to members for violation of the EU and IMF treaties are weak, particularly under the IMF agreement. But, if a eurozone member state also leaves the European Union, then the withdrawal would normally be complicated.

What could other ancillary laws say?

There could be a statutory moratorium on withdrawals from local banks and prohibiting transfers to payees outside the country. These would normally be temporary.

There could be bank holidays while the redenomination takes place.

There could be border controls to prevent the smuggling out of currency notes.

A local statute may provide for the continuity of contracts, so as to avoid the frustration of contracts, and could also override termination clauses.

If a member state leaves the European Union, then it may decide to change many of the EU regulations or statutes inspired by EU directives, such as those applicable to conflict of laws, to jurisdiction and judgments, to financial collateral and to common insolvency rules. It may also change its regulatory rules.

5. How do I work out what gets redenominated and what obligations are blocked by exchange controls?

The rules have been built up by over a century of case law in many jurisdictions and are well-settled in the senior jurisdictions. Normally, you mechanically apply three basic principles to every situation, as follows:

(1) **Scope of currency redenomination laws** You examine the scope of the redenomination or legal tender law and of the exchange controls, especially who they apply to, e.g. local debtors or local residents. There is much history, practice and precedent.

(2) **Governing law principle** You work out whether the governing law of an obligation is local or external. The two basic rules of international recognition of a redenomination law and exchange controls are as follows:

– If the obligation is governed by **local governing law**, it is usually redenominated and blocked unless penal or discriminatory or (possibly) in violation of an EU treaty or similar.

– Obligations governed by an **external law** are usually not redenominated and not blocked, i.e. they are insulated and shielded from a local statute.

If the governing law is express, then most external courts will usually uphold the choice. If there is no express governing law then, normally, you apply centre of gravity tests, e.g. the weight of connections favouring a particular jurisdiction, such as place of performance and location of parties. In Europe there are specific rules on these topics in Rome I which is an EU regulation dealing with the applicable law for contracts.

(3) **Ten exceptions** If the law is external, you then go through the ten exceptions to the insulating effect of an external governing law.

The collective action clauses inserted in eurozone sovereign bond issues do not affect the above rules. Thus a local statute can override these clauses in a bond governed by local law.

The formula is:

Scope of new laws + governing law + 10 exceptions

The ten exceptions to insulation achieved by external governing law

There are at least ten exceptions to the insulating effect of an external system of law.

X1. **Local enforcement only** Even though you have an external judgment from an external court, the debtor only has local assets and so enforcement has to be local. In this case enforcement is likely to be subject to the local legal tender and exchange control rules, because local courts must apply local mandatory laws.

X2. **Local insolvency proceedings** The debtor becomes subject to local insolvency proceedings in which case the local courts are likely to apply their own rules, including the redenomination and exchange control rules. The mandatory application of local law to most insolvency questions is codified in an EU regulation (not applying to Denmark) for companies whose centre of main interests is in the EU. There are similar rules for banks and insurers, extending also to the European Economic Area. A common rule is that foreign currency debts owed by the insolvent are converted into local currency as at the commencement of insolvency proceedings, so that, if the local currency is depreciating and the proceedings last a long time, the foreign currency creditor is expropriated. International businesses may be drawn into local insolvencies because they have other claims with the result that the local courts might claw back violating recoveries obtained elsewhere. Note that generally the law applicable to collateral is where the assets are located and that set-off is permitted if it is allowed by the law governing the debt owed to the insolvent. Note also that strong-arm bank resolution laws might well apply under the EU directive on bank resolutions.

X3. **Local mandatory place of payment** If payments can only be paid mandatorily in the converting jurisdiction and the making of payments is illegal there, under Rome I the courts may refuse to order payment. Courts do not normally order compulsory illegality. It seems probable that in this case the contract would be frustrated, but often the law is unclear. There is no problem if there is an optional place of payment externally.

X4. ***Lex monetae or total break-up*** The contract makes it clear that the payment currency is not the euro generally, but whatever is the currency of the converting state from time to time. In that case, sovereign states can change the currency and most foreign jurisdictions will recognise the change. If California leaves the U.S., its obligations remain in U.S. dollars, except in the unlikely event that the parties meant whatever is the currency of California.

If the eurozone completely breaks up into separate currencies without a euro, then there must be a forced redenomination into the successor currencies partitioned by treaty or by law according to some system of weighting. There could be a case where it is hard to decide if there is a successor euro.

X5. **Exclusive local court** The creditor cannot get an external court to take jurisdiction so that only local courts are available. Local courts will usually then apply mandatory legal tender and exchange control laws of their jurisdiction.

Check if there are express jurisdiction clauses or arbitration clauses and whether the choice of court is exclusive or non-exclusive. Express choice of forum clauses are generally upheld, subject to exceptions.

Under the European Judgments Regulation of 2012, applying to all 28 EU member states and under similar provisions applying to Iceland, Norway and Switzerland, there are special rules for civil and commercial matters (which does not include bankruptcy, arbitration or administrative matters). Generally, persons domiciled in a member state, regardless of nationality, must be sued in the courts of that state, subject to exceptions. The mandatory suit at domicile is displaced by place of performance for contractual suits, place of the harmful event in the case of tort or delict, courts for the place of a branch if the dispute arises out of the operations of the branch, and special rules relating to trusts, actions against more than one party, third party actions, counterclaims and contracts relating to immovables. There is local exclusive jurisdiction in some cases, e.g. immoveable property, certain company matters and registered intellectual property. There are special rules for insurance, consumer and employment contracts. Contracting-out is possible by complying jurisdiction clauses.

In the absence of a jurisdiction clause and outside the European Judgments Regulation, most countries have long-arm or exorbitant jurisdiction rules, such as transaction connections or the defendant has local assets, however small – the "toothbrush" jurisdiction. The long-arm rules depend on the jurisdiction. Almost everywhere the local courts have jurisdiction if a corporate defendant is incorporated locally or has a principal place of business locally, or the defendant has a local branch, although sometimes in this case the action is limited to transactions arising in connection with the branch.

X6. **IMF agreement article VIII(2)(b)** This article of the IMF agreement provides that the courts of member states of the IMF (practically the whole world) will in effect recognise exchange controls consistent with the IMF agreement, which basically means that all capital controls are permitted but controls on current transactions have to be approved by the IMF (which they sometimes are). Hence, this article could override the insulation of an external governing law. However, the article applies only to "exchange contracts" contrary to exchange control regulations. The courts of England, the U.S. and Belgium have limited this (broadly) to contracts to exchange one currency for another, so that it does not apply in those jurisdictions to sales, loans, deposits, bonds and the like. But the courts of France, Luxembourg and Germany have adopted a wider interpretation so that the article could apply to bonds, loans, deposits etc. German case law limits the scope of the article to exchange controls violating *current* transactions which are defined in the IMF agreement but not capital transactions. But in most countries it is possible that the article would be deemed not to be retrospective so as to catch contracts already entered into before the exchange control regulations were introduced – this is an open point. In any event, on the current state of the law, there are higher risks in the courts of such countries as France, Luxembourg and Germany. This may be relevant to governing law and jurisdiction and also to a place of payment in these countries.

X7. **Terms of document** The terms of a document may itself make provision for the impact of a redenomination or exchange control.

X8. **Overriding EU legislation** If a member state were to withdraw from the euro, the eurozone or the wider EU may introduce legislation giving effect to the redenomination and exchange controls so as to override an external governing law. The legislation might neuter express termination clauses.

X9. **Retaliation against local presence** If a firm makes a transaction externally which violates a mandatory local law, such as receiving a payment contrary to an exchange control, the local jurisdiction may retaliate against a local branch or subsidiary of the violating firm.

X10. **U.S. recognition based on location, not governing law** The U.S. recognition of a redenomination and exchange control is mostly based on the act of state doctrine whereby a country can, subject to exceptions, only change an existing obligation if the obligation is located within the territory of the legislating state. In other words, the matter is not just determined by governing law but by other centre of gravity concepts, including place of payment. You often get the same result, but not always, and the outcome is not as clear-cut as determination by governing law.

Examples of application of rules

Example 1 You hold a bond issued by a local bank. The bond is governed by the law of the converting state. The redenomination and exchange control laws are likely to apply and be recognised by foreign courts.

Example 2 A branch in London of a bank whose head office is in the exiting state owes you a deposit in UK pounds. There is no governing law. It is likely that the implied governing law will be English law on the basis of connecting contacts and so the deposit should be insulated from the foreign redenomination and exchange controls, subject to the ten exceptions.

6. Credit default swaps

Prior to the Greek crisis, credit default swaps were documented using the 2003 ISDA Credit Derivatives Definitions (as updated in 2009). The Greek crisis prompted some questioning and much anxiety as to how a euro exit might play out under these definitions. Happily this did not come to pass, but the experience was a main driver for the overhaul of the 2003 Definitions, resulting in the publication of new Definitions in 2014. As a result, there are two different populations of credit default swap in existence. The 2014 Definitions cater more specifically for a euro conversion, meaning that it should be easier for a protection buyer (a) to trigger their contract, by establishing the occurrence of a Credit Event; and (b) to ensure that the protection that they realise is adequate.

Under both sets of documentation, upon a redenomination, binding determinations with respect to the credit default swaps will be made by the Credit Derivatives Determinations Committee established by ISDA. The questions that the Determinations Committee are likely to be asked to address are whether there has been a Credit Event (most likely a Restructuring, but possibly also a Failure to Pay) and if so, which obligations of the Reference Entity will constitute Deliverable Obligations for purposes of the Auction (which will determine the price at which the credit default swap settles).

Under the 2014 Definitions, a redenomination from the euro into a local currency is likely to trigger a Restructuring Credit Event. In order to trigger a Restructuring, the redenomination must be of general application, binding on all holders of the relevant obligation and crucially, payments under the relevant obligation must have suffered an implied haircut as a result. So if there was a purely political redenomination which did not involve an effective devaluation (for example, if the euro/franc rate used to redenominate is the same as the freely available market rate of exchange) then Restructuring would not be triggered. However, in reality this scenario seems rather unlikely.

Under the 2003 Definitions, the position is slightly less clear because the Restructuring definition does not expressly contemplate a euro conversion. Nevertheless, we think it is still likely that a redenomination from the euro into the local currency, in circumstances where holders of the relevant obligation suffer an implied haircut, will trigger a Restructuring Credit Event for Sovereign CDS trades. But an important distinction is that the 2003 contracts require that the redenomination is caused by a deterioration in creditworthiness of the Reference Entity. Whilst this may be fairly easy to demonstrate in the case of a Sovereign, it may be harder to establish with respect to financial institutions and corporates.

Another quirk of the 2003 Definitions arises where a euro obligation is redenominated without a haircut in value. As described above, the 2014 Definitions make clear that this would not be a trigger. The position under 2003 is that this may well lead to a trigger, depending on the precise facts.

If a Credit Event does occur, the Determinations Committee will consider what obligations will constitute Deliverable Obligations for the purposes of the CDS auction. This is crucial as it will determine the price at which the credit default swaps settle. Both the 2014 and 2003 Definitions contain very detailed criteria about what particular attributes a debt obligation must have in order to constitute a Deliverable Obligation. The particular issue which caused so much concern to market participants in the build-up to the Greek crisis relates to currency devaluations. The settlement value of the CDS depends upon the value of the least valuable Deliverable Obligation (the so-called "cheapest to deliver") expressed as a percentage of par. But if a redenomination changes the par value of an obligation then the CDS payout is affected. So if, for example, a €100 bond is redenominated into a 100 franc bond, and a 100 francs are exchangeable into €60, then the bondholder has lost 40 per cent of the value of the bond. But if that bond is trading at par (par being 100 francs) then the CDS payout would be zero. So, essentially, the loss in value caused by redenomination is not protected under a 2003 CDS contract.

This issue was addressed by a major change introduced into the 2014 Definitions – the concept of Asset Package Delivery. This can greatly increase the value that a protection buyer can realise from its CDS protection. Incidentally this is the reason that European Sovereign trades were excluded from the market-wide protocol upgrading trades from the 2003 to 2014 Definitions – it is because the 2014 Definitions are so advantageous to protection buyers it was feared that protection sellers would decline to sign up to the protocol had these been included. In short, it is a mechanism to ensure that in circumstances where a restructuring has altered an obligation which satisfied the requisite deliverability criteria so as to make it undeliverable (either legally, or economically), the protection buyer is not prejudiced by that change. At its most helpful, it enables a protection buyer whose bond has been written down in its entirety to receive a protection payment in full, despite having no obligation. In the context of a euro conversion, it means that a protection buyer is protected against any FX haircut which it would otherwise have suffered as a result of the redenomination. For delivery purposes, the 100 franc bond described in the above example would still "count" as a €100 bond, and so the protection buyer is protected against falls in value from this benchmark. Note however that there are some important limitations in the application of the Asset Package provisions, one of which is that it will only apply in respect of certain pre-selected obligations.

So it is fair to say that a 2014 CDS is a much better hedge against the risks of a euro conversion than its 2003 predecessor. The CDS market has been engaged in much detailed analysis of the basis risk between 2014 and 2003 CDS contracts, and how minutely different scenarios could produce differing outcomes under each. But that is a topic for another paper.

7. What might I be looking for?

What you are looking for depends primarily on which end of the obligation you are on, e.g. whether you are a debtor or a creditor, a bank or a depositor, an insurer or a policyholder, a buyer or a seller, an insurance company or the insured, a custodian or a beneficiary, a receiver of collateral or a giver of collateral etc – basically, whether you have to pay or whether you receive payment. Nevertheless, the principles are the same, although the impact is different.

Set out below are some examples of things you might be looking for. One possible way of doing due diligence is to select a couple of typical counterparties and run the tests in relation to them to get a feel for the methodology.

What might be redenominated and blocked?

What assets or liabilities are likely to be redenominated and subject to exchange controls? You mechanically go through the three rules outlined above (scope of redenomination laws, governing law, the ten exceptions) and apply them to the following, for example:

– Holdings of investments, e.g. sovereign bonds, bank bonds, corporate bonds, warrants for debt or equity, covered bonds, bank or corporate shares
– Loans, lender or borrower (draw-down limits, payments, thresholds)
– Bank deposits (bank or customer)
– Subscription agreements for investments, whether issuer or subscriber
– Intra-group loans and dividends
– Repos and stock lending
– Transfers of loans, whether buyer or seller
– Custodian and sub-custodian agreements
– ISDA master agreements
– Construction contracts, whether employer or contractor
– Foreign exchange contracts
– Sale of land
– Futures contracts, e.g. stock index, commodities
– Sale of goods, especially long-term supply agreements
– Interest swaps, caps, collars and floors
– Sale of energy
– Options, e.g. currency, securities or commodities
– Derivative securities
– Leases of land, whether lessor or lessee
– Leases of equipment
– Credit derivatives
– Leases of ships or aircraft or rolling stock
– Sale of securities
– Licences of intellectual property, licensor or licensee
– Stock lending
– Distributorships and franchises
– Set-off and group account pooling agreements
– Salaries and impact on local staff
– Guarantees, letters of credit and bonding facilities, whether guarantor or beneficiary
– Pensions
– Collateral and margin agreements
– Life insurance cover
– Non-life insurance cover
– Holdings under joint ventures and liabilities under joint ventures
– Payments for mergers and acquisitions
– Financial statements

Mismatches of currencies

A mismatch arises where an asset is denominated in one currency, such as the new currency, whereas a liability is denominated in, say, euro. If the new currency is depreciating, then the new currency will not be enough to pay the liability. In order to find out if there is a mismatch, you simply apply the three rules about redenomination and exchange controls listed above. Examples of potential mismatches are:

– Loans and the funding of loans (bank loans, retail deposits, intercompany loans, corporate intra group loans)
– Corporate liabilities and corporate revenues

- A loan and the revenues from a project or securitisation
- Bond and accompanying interest swap
- A loan sub-participation and the loan itself
- A guarantee and the obligation guaranteed; ditto letters of credit
- Custodians and sub-custodians
- Derivative and the asset hedged
- Collateral and the obligations collateralised

Default and termination triggers

- Events of default and the like may give a counterparty a right to terminate a contract, such as a contract to make a loan (draw-stop) or a long-term supply contract or to terminate a master agreement (such as an ISDA master or a stock lending or repo master or foreign exchange master) and close out, or to accelerate a loan or bond.
- Typical events of default and termination clauses in contracts, bank loan agreements and masters include: failure to pay; breach of evergreen representation and warranty (validity, official consents obtained, no conflict with law, no material litigation, no material adverse change); breach of financial covenant; insolvency; cross-default; material adverse change; illegality; and force majeure. These events may extend to subsidiaries, guarantors and collateral providers. Other triggers in financial contracts include market disruption and increased cost clauses. Financial covenants may be breached because of the depreciation of a currency: this could affect, for example, a leverage or debt service covenant. Consider reserving rights to avoid a waiver.
- In bank credit agreements, consider clauses covering the replacement of a syndicate agent, security trustees or defaulting lenders.
- Note that termination rights may be overridden by insolvency rescue laws in some jurisdictions.

Derivatives

Apart from default and termination triggers, consider also:

- The redenomination could affect underlying reference obligations, assets or indices, as opposed to the actual transaction between the parties, such as an equity option relating to shares of a company incorporated in the existing member state. A local stock exchange index raises a similar point.
- ISDA definitions contain many fallbacks that parties can elect to apply in the case of "disruption" and the like.
- Note that the Illegality Termination Event in the 2002 ISDA Master Agreement is better than the corresponding provisions in the 1992 ISDA Master Agreement. It clarifies that any transaction-specific fallbacks should take effect before the illegality provision applies. It removes the obligation to attempt to transfer transactions before relying on the Illegality Termination Event and it provides for deferral of payments and deliveries during a waiting period before the provision takes effect. ISDA published the Illegality/Force Majeure Protocol in 2012 which facilitates the replacement of the Illegality and Force Majeure provisions of the 1992 ISDA master agreement with the corresponding provisions from the ISDA 2002 Master Agreement.
- Consider whether payments could be withheld under section 2(a)(iii) of the relevant ISDA Master Agreement.

Rating downgrades

Consider the impact on capital, credit risk, collateral, securitisations, etc.

Collateral

Check margin and shortfall requirements, especially if the cash or securities of the collateral are depreciated. Ditto for cover requirements in equipment financings. You may be a collateral giver or a collateral receiver.

Set-off and group account pooling

Set-offs may be affected by a change of currency. This may (unusually) affect group account pooling agreements and bankruptcy set-off.

Imports and exports

Exports may be cheaper and imports more expensive.

Capital and liquidity

The effect of terminations etc. could impact on capital and liquidity in addition to the general disruption caused by redenomination and exchange controls.

Counterparty risks

There may be higher risks of failure of counterparties, e.g. because they have mismatches of currencies, or termination triggers are sparked off. Counterparties include banks and other corporates; payment systems; securities settlement systems; central counterparties; custodians and sub-custodians of securities; insurers, both life and non-life; pension providers; investment managers and their clients; fiscal and paying agents; trustees of bonds; syndicate agent banks; borrowers and lenders; guarantors or letter of credit providers; providers of bonding facilities; buyers and sellers of derivatives; sellers and buyers of goods; lessees and lessors of equipment; licensors and licensees of intellectual property; distributorships and franchisees; outsourcers and providers; construction contractors and employers; buyers and sellers of foreign exchange; repo counterparties; stock lending counterparties; and providers and receivers of collateral.

In practice, a sufficiently detailed knowledge of counterparty exposures will often not be available, except in broad terms, e.g. the counterparty carries on much business in a converting country.

Payment and settlement systems

These would need to project operational changes, e.g. in relation to technology systems, to reflect the new currency. Agreements with participants may have to be amended. Collateral may be affected.

Investment management agreements

Consider investment criteria, liability clauses, termination clauses, fees.

Pricing

Consider potential change of pricing sources, e.g. interest rates and commodities. There may be an impact on technical items such as day-count fractions and business days.

Liability risks

Examples include liabilities under investment agreements with clients, liabilities for mistaken or irrevocable payments, breaches of exit laws.

Operational

Consider the following:

- Where are the documents, including the originals?
- Where is the collateral?
- For agent banks, who are the members of the syndicate?
- Should you line up law firms in potentially converting jurisdictions which do not have existing major conflicts of interest?
- Communication of decisions
- How to stop automated payments
- Adapting systems

8. What protective actions should I consider?

The following are some examples of some actions to consider taking to protect yourself against redenomination and exchange controls if you are pessimistic. Again, the position depends on whether you are a debtor or a creditor, etc, and also upon what can be agreed on existing contracts (usually difficult to renegotiate) and whether agreement can be reached on future contracts.

The following are some examples:

Disinvestment

Disinvest from potential converting countries. This can be like shouting "fire" in a theatre. Examples are disinvesting in the following:

- Bank deposits
- Booking location of bank loans and derivatives (consider transfer restrictions, taxes, increased regulatory costs, commitments to lend, set-off, confidentiality, etc.)
- Investments in sovereign debt or bank debt or corporate debt or shares
- Subsidiaries and local branches
- Local holding companies which hold foreign subsidiaries (should they be moved out so that payments are not blocked?)
- Diverting of payments away from companies in exiting countries, i.e. redirecting payments in chains, such as dividends, transfer pricing
- Sourcing goods and services to other parties

Consider also tax and accounting impact. Consider political risk diversification.

Generally, consider externalising all contacts and assets.

Matching assets and liabilities

The object is to make sure that, if an asset such as a loan, is likely to be redenominated because it is local, then the liability funding the asset will also be redenominated. Examples include:

- A local note issue by a bank to match local loan assets
- Deposits and loans

Documentation

This option involves changing customary drafting in new contracts. Examples include:

- External governing law and courts. Take care to ensure a favourable jurisdiction for purposes of the IMF agreement, article VIII(2)(b).
- Definition of euro. Huge range of possibilities. Either leave it as the "euro" or the currency of the participating members at one extreme or, at the other extreme, specify the currency of, say, Germany. There are many variations in between. Make sure that the contract refers to the euro, not the currency of the departing state, so as to avoid the risk that the exiting state can unilaterally change its own currency (the *lex monetae* principle).
- Ensure that there is an option for an external place of payment.
- Check triggers for default, close-out or termination, e.g. material adverse change clauses, illegality, change of law, cross default, or specific euro clause. Check whether these clauses also apply to subsidiaries, guarantors or the givers of collateral located in an affected country.
- Consider variation and renegotiation clauses sparking on euro breakup, e.g. force majeure, interest rate uplifts or rating downgrades.
- Avoid links to ratings where appropriate.
- Wider ability to substitute obligors in bonds.
- Lenders loosen and borrowers tighten restrictions on assignments and novation of loans.
- Ensure that thresholds are expressed in the right currency for clauses such as financial ratios, cross defaults and negative pledges.
- Are there provisions in loan agreements for the removal of a defaulting lender or an impaired agent? Are there provisions for cashless rollovers? Does a business day include when banks are open in a high risk country in which case payments may be delayed?
- Insert currency indemnities or currency fall-back clauses as a guard against depreciation. Currency top-up clauses might not work in relation to court

enforcement and are unlikely to work in relation to insolvency proceedings.

- Consider change of currency to a safe haven currency.
- Consider disclosure of risk events in offering circulars.
- Consider liability clauses in investment management agreements and other documents.
- Consider the position of local personnel.
- If you are really worried about being drawn into a local insolvency, consider moving the centre of main interests outside a high risk country. This can, however, be complicated and expensive.

Collateral

Consider taking collateral as a protection against collapses in value of obligations but if the obligation is redenominated and the debtor pays it off in a debauched currency, then normally the collateral has to be surrendered. But collateral may be protected if the debtor's obligation is insulated by governing law. Financial collateral may be protected by the Settlement Finality Directive or the Financial Collective Directive in Europe. If collateral is in the form of cash owed to the creditor as a debt, then set-off is relevant.

The main points on collateral are (1) scope of the asset, including whether future collateral is covered, (2) publicity, such as registration in an asset title registry or a debtor-indexed registry, (3) ability to secure future debt, statement of maximum amount, foreign currency debt, (4) transaction costs, (5) priority unsecured creditors such as taxes, employee benefits and post-commencement loans, (6) enforcement, especially private sale, and (7) restrictions on enforcement in the case of insolvency proceedings, such as freezes and the stopping of interest.

Consider also external guarantees from a creditworthy party. Unlike collateral, in many jurisdictions, the guarantee can contain obligations to pay amounts in excess of the redenominated debt, such as a currency top-up.

Hedging

Consider hedging via derivatives.

Set-off

Create set-off by, for example, placing deposits with banks to whom you owe loans with a view to set-off. Bankruptcy set-off must generally be available in relevant jurisdictions but, under the EU Insolvency Regulation and similar bankruptcy directives for banks and insurers in the EEA, insolvency set-off is generally available if it is permitted by the law of the claim owing to the insolvent. Check protections via the Settlement Finality Directive or the Financial Collateral Directive or similar carve-out netting statute in jurisdictions which normally do not permit insolvency set-off. Check any safeguards for set-off in the case of jurisdictions with strong-arm bank resolution laws.

Check counterparty risk

Examples of counterparties are given in section 6 above.

9. What might I do on day zero?

- Check currency and status of all payments going out over the next few days.
- Check currency and status of all payments coming in over the next few days.
- Give priority to the making of payments if a default could trigger an acceleration, close-out or termination.

If these adverse events were to happen, it could be a busy day. Relevant parties would have to consider everything happening on that day and in the coming days, including draw-stops, letter of credit drawdowns, the closing of big deals, margin calls, grace periods and automated payments. It would seem difficult to plan for everything, for every eventuality.

There is likely to be advice from industry associations, such as ISDA.

10. What are the legal remedies against a withdrawing state?

The remedies against a state which withdraws from the euro and introduces exchange controls are weak in most cases. Consider the following heads:

- Breach of treaty if the conversion or exchange control is unilateral. EU treaty remedies are thin, even on paper.
- Human Rights Convention. Difficult to prove in this type of situation because of the qualifications.
- Protections in national constitutions.
- Bilateral investment treaties. It may be difficult to qualify as an eligible investor in the emerging country concerned. This may not in any event be possible after a treaty violation has occurred, such as an expropriation.
- Remedies for expropriation under public international law. Generally very weak and laborious.

This paper is a production of the Allen & Overy Global Law Intelligence Unit, headed by Philip Wood CBE, QC (Hon) who wrote the paper with assistance from others, including David Benton, Matthew Hartley, Yannis Manuelides and Shruti Ajitsaria.

PA to the Intelligence Unit: Melissa Hunt

Allen & Overy LLP

One Bishops Square, London E1 6AD United Kingdom | Tel +44 (0)20 3088 0000 | Fax +44 (0)20 3088 0088 | www.allenovery.com

