Advisory

pillsbury

Corporate & Securities | Corporate & Securities – Technology

January 26, 2012

Cracks in the Eurozone

by James Campbell and Samuel J. Pearse

As the euro crisis deepens both sides of the "Merkozy" couple are full of gloom, and with due cause as this year could see the partial or complete collapse of the currency.

For banks and businesses with contracts which are to be performed in euros the uncertainty is scary. In this Advisory we ask the central question "What effect would a Eurozone breakup (of whatever form) have on private international obligations denominated in euros?" and address some of the English law and private international law issues that in our view will affect this question, namely:

- the principle of *lex monetae*;
- the language used to express the debt obligation;
- the English law concepts of frustration and impossibility;
- the choice of governing law in the contract; and
- the manner and extent of a Eurozone break-up.

Lex Monetae

It is a long upheld principle that a sovereign state has the freedom to chose its currency, and it is the law of the relevant country in force from time to time which gives the meaning to the currency in which a debt is expressed. This is the *lex monetae*.

How the Debts are Expressed

There is a key distinction between the "money of account" (also known as the money of contract or the "money of measurement") and the "money of payment". The former is the measure of the obligation whereas the latter is the money in which that measured obligation must be satisfied.

A private contract which states that the money of payment is "the currency of X" is a clear obligation to make that payment in whatever currency that country has declared as legal tender at the time of payment. This is a straightforward application of the *lex monetae* of that particular country and there is no uncertainty as to what the correct currency of payment is.

However, many contracts will not contain wording along such lines; instead they simply use a generally recognised symbol or word e.g. dollars, euro, £. In this instance, case law and the Contracts (Applicable Law) Act 1990 have established that where there is doubt as to the currency of a debt then we look to the governing law of the contract to determine the money of account, irrespective of where the money is to be paid. So, if an American has agreed to pay an Australian "$100" the law governing the contract will determine whether the obligation is to pay American dollars or Australian dollars or the dollars of any other country.

Using the example of a contract between an English company and a German company in which it is stated that the debt expressed (the money of account) is in euros (or EUR or €), it follows that the measure of that obligation will be determined by applying the governing law. One then has to ascertain the effect of the governing law and, if the governing law is the laws of England and Wales, its application. In this case, a court would ascertain that euros are the relevant currency for measuring the obligation. But this is not the complete story as, if the money of account is not clear, English law requires us to presume that the country most closely connected to the contract will be the applicable country for the measurement of the obligation. This in turn is commonly assumed to be the same as the country of the money of payment. Accordingly, in the example given above, to determine the money of payment, in the absence of clear contractual language English law requires us to look to the governing law of the country in which the debt must or may be discharged, and for debts payable in England the law provides that sterling can be used to satisfy the debt. If the debt is expressed in a foreign currency, then it must either be paid in that foreign currency or in sterling having been converted into sterling by reference to the rate available on that day in a recognised and accessible market (the rate of which may differ from an official exchange rate). So in the example above, if the debt is that of the English company and the payment is to be made in the UK, then the English company would be able to meet its debt by either paying euros or sterling.

Frustration and Impossibility

English law places great emphasis on the enforcement of contractual obligations and it is a principle of English law that monetary obligations cannot be argued to be impossible to perform because the currency in which they are expressed have ceased to exist. The law views an obligation to pay a debt as an obligation to pay that debt in such currency as the applicable *lex monetae* determines to be the currency at the time of payment. The obligation remains but the method of settling the obligation changes.

Using the earlier example of an English party which owes a debt to an German company which is payable in England, it therefore follows that the English party cannot claim that it cannot make the payment in the event that euros cease to exist. Instead consideration of the governing *lex monetae* (in this example that of the UK) would be required to determine the relevant currency of payment.

This means that we have to consider how the euro collapses.

Consequences of a Eurozone Break-up on Euro Denominated Obligations

When considering private international contracts in the context of the euro, there are three linked questions that must be considered:

- What is the manner of the Eurozone break-up?
- What is the extent of the Eurozone break-up?
- What would be the effect of a country exiting the Eurozone on contracts which have a connection to that country?

What is the Manner of the Break-up? When the euro was introduced on 1 January 1999 the 12 Member States entering into monetary union each passed domestic legislation which replaced their national currencies with the euro. From that point, the exchange rate between each of the 12 national currencies and the euro was fixed by way of a European Community Regulation. The 12 national currencies were fully phased out on 1 January 2002. The European Council issued directives designed specifically to ensure the continuity of contracts denominated in those domestic currencies which ceased to be in circulation following the introduction of the euro.

The introduction of the euro was very carefully structured and, importantly, intended to be irreversible. The treaties constituting the Eurozone do not envisage, provide for or permit an exit from it. A structured exit from the Eurozone agreed by all Member States, backed by appropriate European directives and regulation, is currently the only way of lawfully breaking up the Eurozone.

If a structured exit of one of more Eurozone countries occurred, then the surrounding legal framework would give the national courts clear law to follow when determining issues such as the substitution of the euro in private international contracts because:

- the withdrawal would be lawful;
- the relevant national government would introduce a new currency, as is its right;
- that currency would be internationally recognized; and
- the recurrent link between the euro and the new currency would be clearly established such that foreign exchange rates would be without dispute.

Conversely, it is arguable that a unilateral exit from the Eurozone is by definition unlawful. There would be scope for argument as to whether the *lex monetae* of the exited country would be consistently recognised and the relevant national courts of the EU members could each come to different conclusions on the same set of facts. Even the domestic outcome could assume a political dimension. For example, the English courts could on the face of it have strong reasons for not recognising a new currency established in these circumstances on the basis (a) that recognising a *lex monetae* is contrary to English public policy and EU public policy binding on the UK or (b) that in establising the new currency the relevant country was in breach of EU law. But whether an English court would be prepared to disregard a sovereign state’s right of *lex monetae* in the absence of clear direction or judgement by an appropriate authority (such as the European Court of Justice) is not clear and it is likely that Parliament would have to legislate. Indeed the situation could potentially become further complicated as for countries outside the EU there is a higher likelihood that they would recognise the sovereign state's right of *lex monetae* on the basis of comity which could in the event of a partial collapse of the euro lead to different results within and outside the EU.

What is the Extent of the Break-up? If there is a partial collapse but the euro continues to exist amongst a group of Member States, then there remains an internationally recognised, traded and valued currency with which to calculate and satisfy monetary obligations. The question, as discussed above, is whether the courts will enforce a contract on its terms given that there is a readily available currency or, if the obligation is to be satisfied within the borders of an exited country, whether the *lex monetae* of that country prevails. There are strong arguments that the obligations should continue to be expressed in euros, for as long as the currency exists, but there are considerable risks that these arguments may be disregarded.

In contrast , in the event that the euro ceases to exist in its entirety, all contracts with obligations denominated in euros will need to be considered as it will not be possible to satisfy the obligations in euros. And if the contract does not provide a solution, which is unlikely, then one must look at the governing law of the contract, the *lex monetae* principle and the intentions of the parties at the time of settling the terms of the bargain represented by the contract.

What is the Effect on Euro Denominated Contracts? Bringing together all that has been discussed and considered, it is plain that there are a large number of different possible scenarios caused by the number of variables, namely:

- the location of the respective contractual parties;
- the denomination of the debts;
- the place of performance of satisfying the debt;
- the governing law of the contract;
- the courts expressed to have jurisdiction;
- the extent of a Eurozone break-up; and
- the manner of a Eurozone break-up.

Once each of those variables is established, each contract must then be examined on its particular terms and with regard to the circumstances of its creation and the intention of the parties. It is not possible or practical to analyse each possible combination and fact pattern in this Advisory, but we will examine a few scenarios by way of illustration only.

Example 1

- English company A contracts with German company B for the supply of goods by B to A.
- The place of performance of the delivery is England.
- The debts of A are denominated in euros and must be settled in payment to a bank account of B in London.
- The governing law is English law.
- Germany has negotiated withdrawal from the Eurozone, introduced the New Deutsche Mark (NDM) as its national currency and established a fixed exchange rate between the euro and the NDM.
- A has failed to pay its debts and B commences proceedings for recovery.

In these circumstances, it is difficult to see how, whether the case is brought before the German courts or the English courts, the money of account and the money of payment would not be euros. The *lex monetae* of Germany would not have application to the contract and, as it is capable of being performed in accordance with its terms, any judgement given against A should be quantified and payable in euros.

Example 2

Let us consider the same circumstances as Example 1, save that the place of settlement of the debt is a bank account in Germany.

If the dispute is brought before the German courts, would the courts recognise the NDM as the relevant currency of the obligation? Although A is English, the place of settlement is Germany and so German monetary law would have some application. The question is how much. Given the continued existence of euros presumably the German courts would recognise euros as the money of account. As the place of settlement is Germany, it will fall to German law will determine whether the debt can be payable in Germany in euros or in NDM, notwithstanding that the contract is governed by English law. On that basis it is assumed that the German courts would recognise the NDM as a valid currency for the settlement of the loan, but it is also possible the court also rules that the contract can be fulfilled in accordance with its terms and permit A to pay its debts to B in euros.

Notwithstanding A is English, the English courts would presumably take the same view as a German court; it would defer to German monetary law to determine the correct currency of the money of payment.

Example 3

A further variation on Example 2 would be that the contract is a long-standing contract and the debts are denominated in the "old" Deutsch Mark.

If brought before the German courts, it is not automatically clear that German monetary law will apply. After all, A is an English company. If a German court sought to apply its national monetary law, such law would recognise that Deutsch Marks were without question replaced by euros, and subsequently replaced by NDM. It would presumably issue judgement against A to pay its debts in NDM (with euros still being the money of account), the amount of the money of payment to be calculated by reference to the two recurrent links of Deutsche Marks to euros and euros to NDM. If the facts were further varied such that B was the debtor, then there is less doubt that the *lex monetae* of Germany has valid application and it is therefore more likely that a German court would rule in this way.

How would an English court consider the matter? Again, as the place of performance is Germany an English court might look to German monetary law as to how the money of payment would be determined.

If the facts are varied such that the place of payment was England, the English court would have a different set of considerations. It would note that A is an English company, and this would be weighed in the balance. It is without question that the old Deutsche Mark was legally and validly replaced by the euro. However, notwithstanding the legality of the introduction of the NDM, the court would need to closely examine the intentions of the parties when the contract was formed. Did they, when referring to Deutsche Marks, mean the currency of Germany as it may be from time to time? Or was the *lex monetae* of Germany superseded by the *lex monetae* of the Eurozone at 12.01am on 1 January 2002? On these facts, it is suggested that it might be some stretch for the court to establish that the intention of the parties was for the *lex monetae* of the Eurozone to prevail. Consequently, the debt would be measured in euros (for it still exists as a currency) but the money of payment would be NDM or sterling.

Example 4

Reverting to Example 1, what if the Eurozone has ceased to exist in entirety? Our conclusions in Example 1 were that both courts would presumably view the *lex monetae* of Germany as not having application to the dispute and consequently uphold the euro as the relevant currency. So we need to consider again the principles described in "**How the Debts are Expressed**" above to determine the appropriate currency or currencies. However, in doing so we would conclude that the *lex monetae* of the UK applies as that is the place of performance, but it would be highly unrealistic to claim that the parties always intended to contract by reference to the *lex monetae* of the UK for if they did the debts would have been expressed in sterling all along.

There is clearly a debt owing, and as English law places great emphasis on upholding contractual obligations it would initially seem that a debtor cannot claim discharge of its obligations because of impossibility.

The courts might look for nexus to another country, but this does not appear possible in the this example. So the presumption that a debtor cannot claim frustration is weakened, but if a court upheld such a claim that would be decision of great consequence.

Impact of Currency Controls

An additional aspect to the issue is that although an exiting country would in principle be prohibited by EU law from introducing capital controls or a moratorium on the movement of capital or payments, there is every likelihood that they would seek to do so on the grounds of public policy to prevent payments in euros being made abroad. In this eventuality the English courts are highly likely as a matter of domestic law, and as a result of the country's IMF obligations, to recognize the capital controls or moratorium if the contract is governed by the law of the exited country, and potentially also if the place of payment is in the country concerned, on grounds of illegality.

Financial Sector Contracts

Many financial sector contracts are based on standard forms developed by the Loan Market Association and the International Swap Dealers Association or on other market standard forms. In the eventualities described above these templates include some potentially helpful features but they were not drafted in anticipation of a euro collapse and will be subject to the principles of *lex monetae* and illegality and are likely to become difficult to interpret with unpredictable outcomes. There is therefore good reason to review these contracts and see whether they are capable of amendment.

Future Contracts

It does not seem long ago that corporate and finance documentation was being revised for the euro becoming legal tender but with the prospect of a partial or complete collapse of the currency there are a number of suggestions that we would make on how documentation should be further revised to address the payment contingency, namely:

Jurisdiction and governing law. These plainly require thought.

Specify an alternative currency. If a contract is denominated in euros consider whether the contract should specify an alternative currency of settlement and a mechanism for calculating the exchange rate. This could be a different currency like sterling, US dollars or Swiss francs, or another national currency, and could include a definition of the euro.

Specify a place of settlement. Contracts may not necessarily specify where payments are to be made; although it is not uncommon for contracts to specify the destination bank account and this would be indicative. Consider making it express where the obligation is to be satisfied if a particular country's currency is intended to be the currency of settlement. For example, it could be specified that payments in sterling are to be paid in the UK, thereby helping avoid redenomination.

Exchange control. Consider what happens in the event of exchange controls being introduced by a country relevant to the contract. For example, should exchange control be specified as a force majeure event?

Specify a dispute resolution mechanism. A dispute resolution mechanism may avoid the cost and uncertainty of prosecuting claims in a court and assist with reaching a negotiated settlement.

Eurozone exit triggers renegotiation. The contract could specify that in the event a country connected with the contract (e.g. the specified country of payment) exits the Eurozone, the parties will renegotiate a new pricing structure for future supplies of goods or services or the contract will be terminated.

Conclusion

The situation for banks and businesses is complex with a large number of variables, and that is before we have even considered the implications of the introduction of a parallel or replacement currency for the euro as has been suggested by some commentators. In the circumstances the temptation is to do nothing but in our view this risks being overwhelmed when the dislocation that will accompany a euro collapse hits markets. And whatever the newspapers say it is better to be prepared today than to be tomorrow's story.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

James Campbell (bio)
London
+44.20.7847.9504
james.campbell@pillsburylaw.com

Samuel J. Pearse (bio)
London
+44.20.7847.9597
samuel.pearse@pillsburylaw.com