The eurozone crisis, which has been making headlines for months, is creating challenges for EU member states, banks and corporates alike. What are the legal risks associated with these challenges and are there any practical steps that can be taken to mitigate these risks?

Eurozone crisis: economic challenges and legal risks

On 14 December 2011, Herbert Smith hosted a seminar focussing on the economic challenges and legal risks arising from the eurozone crisis.

Presentations were given by Bill Robinson, Head of Economics at KPMG Advisory and a panel of partners from Herbert Smith’s litigation, finance and competition, trade and regulatory practices. The presentations were followed by a discussion, held under the Chatham House Rule.

Here are some of the highlights of the presentations and the discussion.
Bill Robinson started the seminar by arguing that there is not one single eurozone crisis but rather three interlocking crises: a public sector debt crisis, a banking crisis and a competitiveness crisis. Herbert Smith partners followed this by analysing some of the legal risks arising from the eurozone crisis and practical issues that companies may consider taking to mitigate these risks: Dorothy Livingston spoke on the EU law consequences if one or more countries sought to leave the eurozone, John Balsdon drew parallels between the current situation and the Russian debt crisis of 1998-1999 and Adam Johnson set out potential dispute risks. Finally, Matthew Job considered negotiating stances and contractual provisions which may reduce break-up risk.

Three interlocking eurozone crises

Bill Robinson argued that the eurozone crisis should more properly be regarded as three interlocking crises which feed off each other: 

- a public sector debt crisis;
- a banking crisis; and
- a crisis of competitiveness.

The final item, the competitiveness crisis, constitutes the most significant problem but the one which is still not being addressed.

Bill Robinson noted that the banking crisis of 2008-9 sparked the worst global recession since the 1940s, and gave rise, for the first time, to a worldwide negative annual economic growth rate. This, in turn, led to falling tax revenues and contributed to public sector debt problems around the world. In this respect, it is important to distinguish between a country’s “deficit” – the current year’s overspending – and “debt” being the accumulation of all the past years’ overspending. The two are, however, linked, with a given year’s deficit being an indicator of whether the debt problem is getting better or worse.

Public sector debt problems are particularly acute in relation to the EU periphery, where both debt and the deficit constitute a large percentage of the relevant countries’ GDP. Market concerns about this are reflected in the rising cost of the peripheral countries’ debt: the current high borrowing costs for Greece and Italy are well publicised, in stark contrast to the situation in 2009 where the interest rate for ten-year government bonds of each of the eurozone countries was within 1% of the rate for the equivalent German Bund.

The public debt crisis links into the banking crisis as EU member states’ sovereign debt is held by banks around Europe. The current banking crisis has been exacerbated by regulators’ responses to the banking crisis of 2008-2009: many regulators required banks to hold more sovereign debt; debt which is now trading at a fraction of its face value. So a Greek sovereign bankruptcy, for example, would not only cause problems for Greek banks, it would affect banks around Europe.

The third crisis relates to competitiveness, or balance of payments, and is a problem for many peripheral eurozone countries which have lost competitiveness against Germany since joining the eurozone. As a rule of thumb, if a country has a 15% competitiveness gap, an exchange rate adjustment (devaluation) is thought necessary. The UK underwent such a devaluation when it left the Exchange Rate Mechanism in 1992 and allowed the pound to float, but a country within the eurozone cannot remain in the eurozone and devalue against the euro. Greece has suffered a 28% competitiveness handicap since it joined the euro and it now faces the choice of whether to restore competitiveness or not. There are two possibilities for restoring competitiveness: either maintaining inflation at a rate approximately 3% lower than that of Germany for about 10 years (an unlikely outcome, since Greece’s inflation rate is usually about 3% higher than that of Germany). The alternative is for Greece to leave the euro and float its new currency, which would immediately devalue. This would cause its own problems, not least a run on Greek banks.

The solutions recently considered by eurozone leaders aim to address the public debt and banking elements of the eurozone crisis, but do not address the competitiveness aspect at all, leaving the peripheral countries in the euro, but permanently depressed and with low growth.

For example, Germany is keen on fiscal retrenchment, but this inhibits growth and countries need an export-led growth in order to address the public debt crisis. Sanctions...
have been suggested to prevent a repeat of countries running huge deficits, but the existing framework for imposing fines in those circumstances already appears in the EU treaties and is not well policed. The more effective sanction appears to be that of the market, which imposes prohibitively high borrowing costs on countries with huge deficits. Even if a common fiscal policy to underpin the common monetary policy was agreed, this would not solve the competitiveness problem.

The eurozone crisis has consequences for the UK: UK manufacturing output fell dramatically during 2008-9 and is showing few signs of recovery, despite a competitive exchange rate. Most of the UK’s trade is with European countries: 75% of the UK’s manufacturing output goes abroad, most of it to the eurozone, so as long as the eurozone remains depressed, prospects for an export-led growth for the UK remain small.

In conclusion, Bill Robinson considered the consequences of the crisis: slower EU growth, which has an impact on companies’ share prices, the possibility of a sovereign debt default, which would have an adverse impact on banks, and finally the possibility – an unlikely outcome but one that cannot be ruled out – that one or more countries may leave the eurozone, with the associated impact of currency change on capital values.

**What if a country leaves the eurozone?**

Dorothy Livingston, a consultant in Herbert Smith’s trade, regulatory and competition practice, considered the last of these consequences. She noted that, even if it is unlikely that one or more countries will leave the eurozone, it is a risk to be analysed and, where appropriate, addressed.

There are many possibilities if one or more countries decide to leave the eurozone: the departing countries may be economically weak or economically strong; they may leave with the agreement of the remaining countries (a neater solution) or with no agreement. If the departure of a member state from the eurozone was through an agreement enshrined in EU law, that member state would need to establish their own rules for their new currency. They would need temporary derogations from the EU’s free movement of capital rules to allow the exiting member state to institute exchange control restrictions, and there may also be EU legislation addressing redenomination of existing debts – at least those owed by banks and the exiting member state.

If a country left the euro without there being any such agreement, this would give rise to many uncertainties, not least whether the secession, redenomination and new currency would be recognised by other member states. Leaving the EU without agreement takes two years, during which time the law of the departing member state will theoretically continue to contain EU obligations to use the euro as its currency and any exchange controls imposed by the member state would infringe rules on the free movement of capital.

If the eurozone countries and those who have signed up to join the euro decide to abandon the experiment and break up the eurozone completely, those countries could agree to do so (UK consent would not be required as the UK is not bound by the relevant treaty provisions) but they would still need to use a treaty amendment to introduce temporary exchange controls to protect that currency. Questions would remain about the currency of account for payments, but this may be addressed by agreeing to redenominate existing debt according to a rule, such as using the national currency of the payer or the currency of the place where the debt is incurred. Such a rule could be incorporated into the law of all relevant member states and recognised elsewhere as the “lex monetae”.

The possibility of the eurozone breaking up without any kind of agreement is unlikely, and would cause legal and economic chaos.

Dorothy Livingston concluded that there is merit in adding contractual fall-backs to cater for the possibilities outlined above. Fall-backs would be particularly valuable if there is a no agreed solution among member states and it is unclear whether new laws of an exiting member state are valid. Contractual provisions may also provide a clearer or fairer outcome for the parties even where a redenomination mechanism has been agreed between relevant states. The final speaker, Matthew Job, suggested options for fall-back wording.

**Russian lessons**

John Balsdon drew on his experiences of the Russian market during its debt crisis of 1998-1999 to provide some practical tips on dealing with the consequences of exchange controls and payment moratoria.

The Russian debt crisis was driven by economic circumstances, in particular the falling price of oil, which drastically lowered tax revenue, causing Russian government debt to become unsustainable. The Russian government introduced exchange controls, a moratorium on foreign and domestic payments for all entities and legislation which was intended to give the Russian economy and Russian companies some breathing space, but which had a number of unintended consequences. The rouble suffered a massive devaluation, from 6.5 roubles to the dollar to 24 roubles to the dollar – almost a 400% increase in costs for companies with domestic revenues and foreign payment obligations. Banks were hit hard as depositors withdrew money from the banks; many banks had borrowed in USD and had to meet these payment obligations; and many corporate borrowers became insolvent, requiring banks to write off loans and reduce their balance sheets.

Creditors initially started to examine their contracts with Russian borrowers, to establish what claims they had against non-paying Russian counterparts. However, the debt crisis spiralled and soon creditors needed to focus on insolvency procedures rather than contractual claims. Since some insolvency procedures have a short deadline for filing claims, this led to a huge administrative burden in preparing the claims, particularly since many documents needed to be translated, notarised and apostilled.

Some Russian borrowers sought to restructure their debt, and evaluating these restructuring offers required a huge amount of senior management time.

Much debt trading went on, with some borrowers buying the debt of their Russian lenders at a significant discount and setting those amounts off against their own debt at par. Further management time and expense was used in
questioning the legalities of this approach. Some lenders seized assets of Russian borrowers – particularly foreign currency deposits held in banks that were located outside of Russia – and netted these deposits against amounts owed to them and then waited to be challenged by Russian insolvency officials. The legal system in Russia struggled to cope with the great number of claims that arose. There were few insolvency practitioners, and an insufficient number of judges to deal with the volume of claims. The judges also had to decide whether to enforce foreign arbitral awards or refuse on the grounds of public policy.

What lessons can be learnt from the Russian experience? In summary, be prepared!

- Know where your documents are – ideally they should be located in one place where you are able to access them quickly.
- Be familiar with the insolvency procedures in countries you are concerned about, particularly the deadlines for submitting claims and procedural requirements such as translating and notarising.
- Be on the front foot – do not wait for the crisis to occur and then have to react.

Avoiding torpedoes

Adam Johnson considered dispute risks, particularly those connected with choice of law and choice of jurisdiction.

He noted that international litigation is concerned with two main variables: the law applicable to a claim (the governing law) and the jurisdiction or forum in which the claim will be fought. Sometimes the two are interlinked, as different jurisdictions have different procedural rules, giving different results on the same set of facts. For example, in Kleinwort Benson Ltd v Glasgow City Council (No.2) [1999] 1 AC 153 a bank tried to claim against the city council in connection with a void swap agreement. A preliminary matter was argued before the House of Lords: whether the case should be heard in Scotland, applying Scottish law with its shorter limitation period, meaning that the bank would no longer be able to enforce its claim. A court may override what is otherwise the applicable law of a claim (including a contractual choice of law) and apply mandatory provisions of its own law or public policy. There is, therefore, a risk that if an English law contract is litigated in (for example) Italy or Greece, that English law may not be applied at all.

If more than one court within the EU has jurisdiction over the same dispute, the Brussels Regulation provides that the court “first seised” will keep jurisdiction. This has encouraged “forum shopping” by some defendants, and the use of an “Italian torpedo” to prevent or delay contracts with an English jurisdiction clauses from being heard in the English courts. The “Italian torpedo” was developed in patent, trademark and infringement cases, where a prospective Italian defendant would start proceedings in its own forum, seeking a negative declaration, i.e., a declaration of non-liability. In this way, the Italian defendant can take advantage of the delays and idiosyncrasies of the Italian legal system and hinder a claimant from bringing proceedings in England.

The Italian torpedo is effective even if there is an exclusive English jurisdiction clause; you cannot obtain an injunction from the English courts to prevent the Italian defendant continuing its proceedings in Italy. In Turner v Grovit [2005] 1 AC 101 the European Court of Justice decided that an anti-suit injunction is incompatible with the “court first seised” rule of the Brussels Regulation. You cannot continue litigation in England even if the only procedure in another EU member state is a challenge to the jurisdiction of the Italian courts; you must wait for the conclusion of the foreign proceedings (Erich Gasser v MISAT Srl (Case C-116/02), [2005] QB 1; J.P. Morgan v Primacom [2005] EWHC 508 (Comm.), [2005] 2 Lloyd’s Rep. 655).

These rules are clearly unsatisfactory, and are under review by the European authorities, but in the meantime they remain in effect and should be taken into account if planning a litigation strategy.
In conclusion: be prepared and think seriously about getting in first!

Redenomination risk mitigants

Matthew Job, noting that we are in a period of Rumsfeldian “known unknowns” in relation to the future of the euro, described some protections that parties may want to consider in relation to their contracts and, where appropriate, include in their documentation.

First, the currency of payments in any contract is a choice of the parties, and is a choice that should be made advisedly. Is euro the most sensible currency to use or would another currency give the parties greater certainty? By euro, do all parties mean a pan-European currency or the domestic currency of a particular member state from time to time? If all parties agree, should that choice be written down? If a contract does contain provisions allowing for redenomination from euro to one or more other currencies, the contract should be reviewed and any necessary consequential changes made to ensure that the contract makes commercial sense (for example, setting interest rates by reference to EURIBOR will no longer be appropriate).

Second, parties should consider the way they enter into contracts. This can only be considered on a case-by-case basis in light of the parties’ negotiating positions. Those companies based in “weak” eurozone countries may want to “internationalise” their income (thereby minimising the chance of it being redenominated from euro to a new currency) and “domesticise” their expenses, to take advantage of any devaluation that would likely happen to a new currency. Companies based in a “strong” eurozone may want to do the converse. They should take into account factors such as whether to contract through local or foreign entities, the place of payment and choice of law and jurisdiction. Another consideration is the tenor of the contract – short-term contracts may be preferable for a company in a weak country about to take on euro-denominated liabilities.

The third and most contentious point, which will vary with the parties’ negotiating position, is whether a party can improve its commercial position on redenomination. Should the euro be defined by reference to the currency of a particular member state? It may be difficult to persuade an Italian counterpart, however, that euro should be defined as the lawful currency of the Federal Republic of Germany from time to time. Should the contract allow one party to discontinue to redenominate the currency of payment where a country has a choice of two currencies? This may seem fanciful, but the Loan Market Association’s (LMA) change of currency clause seeks to achieve this. Should the contract provide for redenomination into another specified currency if there ceases to be a “qualifying euro”? This provides a neat solution mechanically, but will likely lead to much negotiation on what constitutes a qualifying euro. Should the contract provide for the suspension or termination of contracts on a euro break-up.

Discussion points

In discussion, the panel considered whether a country leaving the eurozone or a break-up of the eurozone would constitute a force majeure event. In contrast to the doctrine of frustration, which requires some kind of illegality or impossibility of performance, force majeure uses the broader concept of hardship caused to one of the parties to a contract. It is therefore conceivable that a party might try to rely on a force majeure provision to excuse or suspend performance of its obligations if the currency conversion makes it difficult to perform. The panel noted that when the euro came into being, EU legislation was passed to ensure continuity of contracts on a country’s entry into the euro. In the absence of any legislation or agreement, whether a country’s departure from the euro would constitute force majeure would depend on the drafting of any force majeure clause and the law of the relevant country. The wording will be important as an English court would be reluctant to accept that a redenomination constituted a force majeure event, as it would still be possible for the payment obligation to be performed. However, the 2002 ISDA Master Agreement contains a force majeure termination event and there has been speculation in the market whether this would be triggered by a redenomination. Force majeure clauses may be triggered in oil and gas supply documents which usually contain a broadly worded force majeure clause.

The panel were asked for their views on when the ECB would act on a larger scale. The panel noted the criticism of EU leaders that their actions in dealing with the eurozone crisis were too little, too late. But this is, in part, a pragmatic response as EU leaders need to keep in mind their electors in their home states who may have little appreciation that the eurozone crisis threatens competitiveness across the entire EU. The ECB is being called to do two things: first, acting as a lender of last resort to failing European banks (which seems a sensible role for the ECB) or alternatively, buying the debt of peripheral eurozone countries, effectively propping up the governments of those countries, a less suitable role for the ECB.

The panel was asked whether banks are looking to include additional protections in facility documents to deal with one or more countries leaving the eurozone. In the panel’s experience in some facility negotiations, the topic has been debated by syndicate members – especially where the syndicates include both US and eurozone banks – but ultimately no changes were made in this respect to the LMA form of wording.

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