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The Eurozone and Commodity Contracts 1

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The possibility of one or more countries exiting the European Monetary Union (the "**Eurozone**") has been well publicised. It is becoming increasingly important for businesses to understand the implications of different scenarios for the future of the euro.

This is the first of two *alerts* that consider the legal risks for commodity and energy traders, arising from either a Eurozone Exit (i.e. where one Eurozone Member exits the Eurozone) or a **Eurozone Break-up** (i.e. the disappearance of the euro altogether).

This alert focuses on the risk of redenomination of euro payment obligations into a new national currency. The next alert will look at whether a Eurozone Exit or Eurozone Break-up will cause the "frustration" of contracts or trigger "force majeure" or "material adverse change" provisions.

Of course, it is imperative that other, more commercial risks are also assessed at this critical time in order to carry out fully effective "euro contingency planning", e.g. credit risk on counterparties affected by Eurozone events. In addition, it is important for traders to be prepared for the situation to be affected by events at the time. For example, the redenomination of a particular contract may be affected by how a Eurozone Exit takes place, e.g. whether an exit from the Eurozone by a Eurozone Member is accompanied by an exit from the EU itself.

Eurozone Exit

Redenomination

While most commodities are traded in U.S. Dollars, there are important markets where trading is in euros, including many European power and gas markets and the market for EU emissions allowances.

In the event of a Eurozone Exit, the exiting state may introduce a new national currency and redenominate debts owed in euros by its nationals or payable within its borders into that new national currency. Any euro payment obligations owed under a contract with an entity connected to the exiting state may therefore be subject to conversion into the new national currency. Various factors will affect how serious the risk of redenomination is. We consider a number of those factors in turn.

(a) The law chosen to govern the contract — The law which the parties have chosen to govern a given commercial contract and the jurisdiction in which the parties have agreed that disputes are to be heard will affect the risk of payment obligations being redenominated.

Where the governing law and jurisdiction of a particular contract is that of an exiting state, and the euro payment obligations fall within the scope of the exiting state's redenomination legislation, payment obligations under that contract will be redenominated into the new national currency, which is likely to be of depreciating value. This is also likely to be the case where a dispute is brought before a court of the exiting state, but the governing law of the contract is that of a non-exiting state, as the court is likely to apply its own redenomination legislation.

Similarly, where the governing law of a contract is the exiting state, but a dispute arising out of that contract is heard in the jurisdiction of a non-exiting state, the courts of the non-exiting state are likely to redenominate payment obligations into the new national currency, unless a court considers that public policy factors should prevent this.

Likewise, an arbitral tribunal resolving a dispute governed by the law of an exiting state would apply the redenomination law of the exiting state. However, English courts have held that, where appropriate, an English arbitral tribunal may refuse to enforce a foreign law provision (for example, on the basis of illegality), but an arbitral tribunal sitting in England is arguably less likely than an English court to refuse to enforce a foreign law provision on public policy grounds.

(b) Jurisdiction and seat of arbitration — Even where the contract provides for the exclusive jurisdiction of the English courts (or the courts of a state other than the exiting state), there is always a risk that the exiting state may assume jurisdiction. Where proceedings are initiated in the courts of the exiting state, the English courts will have to wait until the exiting state has declined jurisdiction. If the courts of the exiting state assumed jurisdiction, the redenomination legislation would likely to be applied and, importantly pursuant to the Brussels I Regulation, English courts are obliged to recognise a judgment of the courts of the exiting state unless it is manifestly contrary to English public policy.

Similar risks arise in relation to a contract that includes an arbitration clause. The New York Convention 1958 provides that when a court of a contracting state is seized in relation to a matter which the parties have agreed to arbitrate, the court must, at the request of one of the parties, refer them to arbitration unless it finds that the arbitration agreement is null and void, inoperative, or incapable of being performed. Under English law, the Arbitration Act 1996 gives effect to the New York Convention.

There may therefore be tactical benefits for a party to commence court or arbitration proceedings as soon as possible so as to avoid being pre-empted by proceedings being commenced by its counterparty in the exiting state.

(c) Intention as to which currency is to apply — Where a contract is governed by English law and a claim comes before the English courts or an arbitral tribunal, a key question will be whether the contractual intention is for the currency of payment to be (i) the single European currency, or (ii) the currency of the exiting state from time to time. The courts will look at the following factors to determine this.

- *Definition of "euro"* - Where "euro" has been defined by reference to the single European currency, the risk of redenomination is lower, as an English court or arbitral tribunal is likely to conclude (subject to the place of payment – see below) that the single European

currency is the intended currency of payment. If "euro" is defined by reference to the currency of the exiting state, it is clear that the parties intend payment to be made in the currency of the exiting state from time to time and we would expect a court or arbitral tribunal to redenominate euro payment obligations into the new national currency.

- *Place of payment* - Under English law, there is a presumption that the parties intend the currency of payment to be the currency from time to time of the country in which payment is required to be made. The presumption may be rebutted where the contract provides for a place of payment outside the exiting state or multiple places of payment in more than one country. But in the absence of other factors that outweigh the presumption, if the required place of payment is the exiting state, an English court would consider the currency of payment to be the new national currency.

(d) Conflict of laws and public policy — Any court to which a dispute is submitted will apply its own rules, including conflict of law rules, to determine the country whose domestic laws should resolve the matter.

Where a contract is governed by English law and a dispute comes before the English courts, an English court may choose to give effect to the exiting state's redenomination law, even where it is clear that the currency of payment is the single currency. This may be necessary where the place of payment is an exiting state and its redenomination law not only redenominates payment obligations into the new national currency, but also makes payment in euros illegal, for example, by establishing exchange controls (see below). An English court has no discretion to refuse to enforce those contractual payment obligations pursuant to the Rome I Regulation, unless to do so would be contrary to English public policy (e.g. because it is inconsistent with the EU treaties or is confiscatory or discriminatory).

It should be noted that the Rome I Regulation does not apply where the contract includes an arbitration clause or where the contract is made before 17 December 2009. Further, it is questionable whether the Rome I Regulation will apply where the exiting state does not remain in the EU. In any event, it is highly unlikely that a court or arbitral tribunal would order payment, which would be considered illegal in the place of performance.

Exchange controls

In order to stabilise the new national currency, the exiting state may introduce exchange controls.

Pursuant to the International Monetary Fund ("**IMF**") Agreement, the UK is obliged to enforce exchange control regulations relating to "exchange contracts" imposed in accordance with the IMF Agreement by an IMF member.

However, each IMF member may interpret differently what it classifies as "exchange contracts". English courts have interpreted the term narrowly such that the term is confined to the exchange of the currency of one country for the currency of another. Other IMF members have interpreted "exchange contracts" more widely so that any contract dealing with the exchange of goods or services which impact foreign exchange reserves is considered an exchange contract. Although

we do not expect exchange contracts to be construed to include a contract for the sale and purchase of commodities (or options thereon), specific advice will be needed on a case-by-case and jurisdiction-by-jurisdiction basis.

It should be noted that generally the Treaty on the Functioning of the European prohibits the introduction of exchange controls, but an exiting state may justify exchange controls on grounds of public policy or public security. For this to apply, the exiting state must remain in the EU. A unilateral Eurozone Exit that has not been subsequently ratified by the EU is not likely to be regarded by the European Court of Justice as falling within this exemption.

Enforcement

Judgments made by the courts of the exiting state redenominating payment obligations could, in theory, be enforced throughout the EU under Brussels I Regulation, although an affected party may seek to resist enforcement on the ground that it is “manifestly contrary to public policy” in the enforcing state. Such ground for exemption from the obligation to enforce the judgment would apply, for instance, where the exiting state has exited in breach of EU legislation.

Equally, if payment obligations under a contract have not been redenominated, enforcing a judgment or arbitral award requiring payment in euros in the exiting state may be difficult, as the courts of the exiting state are unlikely to enforce a judgment that conflicts with its redenomination law.

Eurozone Break-Up

If the Eurozone broke up and the euro as a currency ceased to exist, then the currency into which euro obligations are redenominated would, absent legislation addressing the point, be determined using similar factors to those considered above.

In all likelihood, the UK and other European countries would introduce national legislation to deal with this issue, possibly reflecting an international treaty dealing with the new monetary landscape. Any such international treaty is likely to codify the “Eurozone Exit” factors detailed above so as to identify the state with the closest connection with the contract.

Managing Risks of Exposure

The following pro-active measures may help mitigate future risks:

- *Defining the “euro”* – The “euro” should be defined in relevant commercial contracts by reference to the single European currency. This should reduce the circumstances in which a court or arbitral tribunal outside an exiting state will order payment in the new national currency.

- *Agreeing with the counterparty a new place of payment* – The parties can agree that payments are to be made in a country outside the Eurozone or which is in the Eurozone but is viewed as unlikely to be an exiting state. This would help to avoid or reduce some of the risks arising from the exiting state being the place of payment (i.e. redenomination and frustration).

- *Law and jurisdiction* – Where a counterparty is from a potential exiting state, the parties should choose the law and jurisdiction of a low-risk state, e.g. choose English law and submit to the exclusive jurisdiction of English courts.

Conclusion

Once an area of potential exposure has been identified, steps must be taken to manage and minimise its potential impact, such as reviewing key contracts, renegotiating and amending contracts, and taking legal advice. Any euro contingency plan should address not only the risk of redenomination, but also other risks such as contract termination risks (as will be examined in our next alert). Given the continuing uncertainty regarding the resolution of the Eurozone crisis, any contingency plan will need to remain flexible so as to allow modification as required.

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