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Potential Impact of a Eurozone Break-up on Foreign Exchange Swaps and Currency Options Contracts

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A principal use of options and swaps is to hedge currency risk. The adoption of the euro as a common currency for a group of European countries in the eurozone (and before then to a limited extent through the European Currency Unit and the associated exchange rate mechanism) had a profound impact on currency risk, as it eliminated currency exchange risk within the eurozone.[1]

Correspondingly, a break-up of the eurozone would have important implications for euro-denominated derivatives arrangements, perhaps calling into question whether existing transactions denominated in euro provide viable hedges for obligations that have been redenominated into new currencies. Questions may arise regarding the impact of a redenomination on the performance obligations of parties to transactions and ultimately the pricing of such transactions. The risk of redenomination of FX transactions payable in or involving delivery of euro highlights the necessity in analyzing contracts that contain euro obligations.

This alert will consider the impact that the withdrawal of one or more countries from the eurozone may have on currency swaps and options that involve the payment or delivery of euro, whether by a non-eurozone swap participant or by a counterparty seeking to hedge risks specific to a country that has ceased to use the euro. It will first outline the scenarios in which a eurozone break-up may occur, then will outline the basic documentation for foreign exchange transactions and finally will analyze how a eurozone break-up under the specified scenarios may intersect with the transaction documentation in perhaps surprising ways. The focus of this article is on how a currency redenomination may affect currency derivatives transactions rather than the circumstances in which a redenomination could occur.

Analyzing a Break-up of the Eurozone

Potential Scenarios

A potential break-up of the eurozone may occur in several different ways that may affect rights and obligations in currency derivatives. In the most limited scenario, a relatively small country such as Greece or Portugal withdraws from the eurozone and the euro continues to exist as the legal tender of the remaining members of the eurozone. While this scenario would raise legal questions regarding whether such a country would also have to withdraw from the EU, those questions are not relevant to our analysis. In a broader scenario, the euro would cease to exist as a legal currency, perhaps as a

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1 The eurozone consists of 17 of the member states of the European Union ("EU") that have adopted the euro as a common sole legal tender. Those states are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, the Slovak Republic, Slovenia and Spain.

consequence of a dissolution precipitated by a core eurozone member such as Italy defaulting on its sovereign obligations or withdrawing from the eurozone.[2]

Each of the foregoing scenarios could involve one or more eurozone member states displacing the euro as its legal tender and re-establishing its own domestic currency. That process could conceivably take several different forms. A member state could choose to redenominate its currency but not its current obligations, or it may choose to redenominate a class of obligations into the new domestic currency. A member state having exited the eurozone could be expected to impose exchange controls affecting both the export of the new domestic currency abroad and the conversion of foreign currency including the euro into the domestic currency.

Legal Jurisdiction

The question of whether or not foreign obligations may be redenominated from euro into a new currency brings into play a host of jurisdictional and governing law issues. For purposes of considering how such a redenomination may affect currency derivatives transactions, it is necessary to consider two categories of contracts. The first comprises the derivatives transaction itself. The second category consists of the underlying obligations that may be directly or indirectly referenced in such transactions or that may represent the currency exposure that is being hedged.

The risk that a particular obligation relevant to a currency derivatives transaction may be subject to redenomination likely would depend on the jurisdiction under which the obligation arises and could also be influenced by the nature of the break-up scenario. Obligations governed by the local law of the exiting state likely may be redenominated from the euro to the new domestic currency by decree. However, obligations that are governed by foreign law will not be susceptible to redenomination by decree because the exiting member state would not have the power, by its own statute, to change the foreign law and would be likely to be redenominated only if and to the extent that the contract expressly provided for redenomination or that a court determined that redenomination was appropriate.

The extent to which a break-up of the eurozone may impact the rights of parties to a currency derivatives transaction may depend on whether the number or importance of the withdrawing countries is so great as to precipitate a general collapse of the eurozone and lead to the definitive demise of the euro as a currency unit.

In scenarios in which the euro continues to exist as a currency, courts may be called upon to decide whether to enforce the contractual currency of obligations denominated in euro or whether to redenominate contractual obligations into another currency. Factors that a court might take into account in determining whether redenomination is appropriate could include contract law doctrines of frustration, impracticability or impossibility of performance owing to redenomination of the obligation being hedged and the doctrine of *lex monetae*, *i.e.*, whether the obligation has such a nexus to a

2 While in theory a member may unilaterally withdraw, a negotiated withdrawal is the only likely scenario for several reasons. Because the imposition of exchange controls would be a violation of the Treaty of Rome, a member state that imposes such controls would run the risk of being expelled from the EU, which a member state would not lightly undertake. In addition, because all foreign reserves of EU member states are held in the European Central Bank a departing member state would have to negotiate its exit in order to operate a new own currency. Note also there are no provisions allowing other member states to force a member out. For an analysis of various scenarios in which a eurozone break-up might occur, see J. Nordvig, “Currency Risk in the Eurozone: Accounting for break-up and redenomination risk,” Nomura Foreign Exchange and Strategy, January 2012.

particular jurisdiction that the obligation should be denominated in the currency of that jurisdiction regardless of whether the contract specifies another currency.[3]

Documentation for FX Transactions

General

The impact of a eurozone break-up on a specific currency derivatives transaction would depend to a great extent on the nature or class of swap and the relevant definitions associated with that asset as well as on the elections made by the parties in the documentation governing the transaction.

Currency derivatives are generally documented under three basic forms of standard master agreement. One of these is the 1997 International Foreign Exchange Master Agreement (the "IFEMA form"), which was drafted under the auspices of the Federal Reserve Bank of New York and some other market groups. In addition, the International Swaps and Derivatives Association ("ISDA") has published two forms of master agreement, one in 1992 (the "1992 ISDA master agreement") and the other in 2002 (the "2002 ISDA master agreement"; collectively, the "ISDA form"), both of which have long been used for currency derivatives traded over-the-counter. Negotiated contractual terms of general applicability to the parties' swaps relationship are contained in a schedule that modifies the provisions of the ISDA form and each transaction has a confirmation that contains the basic economic terms of the transaction. Collateral or other credit support may be provided through a guaranty or a security agreement, often in the form of a credit support annex in the form published by ISDA. In general currency derivatives transactions are governed by English law or New York law.

The 1998 FX and Currency Options Definitions

Transactions under the ISDA form are subject to detailed sets of definitions, some of which (like the 2000 or 2006 ISDA definitions) apply generally and some of which are relevant only to particular types of transaction. The basic terms that apply to most currency derivatives are contained in the ISDA 1998 FX and Currency Option Definitions (the "1998 Definitions"). The 1998 Definitions contain general provisions for valuation, settlement and delivery under a range of currency derivatives. They also contain, in an annex, standardized definitions regarding particular currencies for use in transactions.[4] Perhaps of greatest importance for the fragmentation of a currency union are the provisions of section 5 of the 1998 Definitions, which relate to disruption events and their consequences.

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3 A court considering whether a payment obligation denominated in euros is effectively redenominated into a new local currency under that doctrine after a member state of the eurozone leaves the euro likely would consider the following factors: (a) the governing law of the contract, (b) the jurisdiction in which the court considering the contract is located, (c) the actual or presumed intention of the parties to the contract with regard to redenomination, (d) the place of payment as specified in the contract, (e) the location of the obligor, (f) whether the exit of the relevant member state from the eurozone was unilateral or by agreement with the other member states of the EU and (g) whether the euro continues as the lawful currency of the remaining member states of the eurozone. For a detailed discussion of this topic, see C. Proctor, Mann on the Legal Aspect of Money at chapter 27. See also C. Ball, "Distress Investing in Europe: Currency Risk Looms," New York Law Journal, December 22, 2011. Courts in EU members states may assess the application of these factors to a euro-denominated contract differently than might a court in a non-EU jurisdiction such as New York for several reasons, including that EU treaty obligations of the court's jurisdiction may raise unique public policy issues and other legal considerations.

4 Interestingly, although the 1998 Definitions address in a rudimentary way the adoption of the euro and its predecessors, the annex has never been amended to eliminate currencies of countries that adopted the euro. Consequently, if such a country were to reissue its own currency under the same name as its former currency the 1998 Definitions would appear to be available for new transactions referencing those currencies. This discussion addresses only the impact of a eurozone event on existing transactions.

Application of the 1998 Definitions to Transactions Under the IFEMA Form

Section 6 of the IFEMA form provides that the occurrence of a force majeure event or an act of state is a termination event that gives rise to close-out liquidation of affected transactions in accordance with section 5 of the IFEMA form. Depending on the facts of a transaction and the nature of dissolution of the eurozone, a currency event associated with a withdrawal of a state from the eurozone may well constitute an act of state or force majeure event applicable to such a transaction.

However, section 5.1(c)(ii) of the 1998 Definitions provides that if a transaction is governed by an IFEMA form and an event or circumstance that would otherwise constitute or give rise to a force majeure, act of state, illegality or impossibility for purposes of section 6 of the IFEMA form also constitutes a disruption event as defined in the 1998 Definitions, then such event or circumstance will be treated and resolved as a disruption event under the 1998 Definitions. Although one may question whether such provision would be enforceable on parties to an agreement under an IFEMA form that does not incorporate the 1998 Definitions into the agreement, parties to transactions documented under IFEMA forms often explicitly make the 1998 Definitions applicable to those transactions.

Disruption Events and Disruption Fallbacks Under the 1998 Definitions

The 1998 Definitions contain various disruption events and fallback settlement options that could apply to a currency transaction if one or more countries were to leave the eurozone. The 1998 Definitions contain a long list of both that parties could select and that could well be implicated by a eurozone break-up depending on the circumstances in which a crisis of euro disintegration were to unfold.[5]

Disruption Events

Despite the detailed enumerations of disruption events in the 1998 Definitions, the parties to a transaction generally must specify the disruption events that apply to that transaction. In the absence of an affirmative election the parties to a nondeliverable [i.e. cash settled] transaction would not have selected any disruption event at all. In the case of a deliverable [i.e. physically settled] transaction the parties in that case would be deemed to have elected only the disruption event for price source disruption contained in section 5.1(d) of the 1998 Definitions. The failure of a disruption event to occur could significantly affect the utility and the price of a transaction. Even the default election for deliverable transactions may have unexpected consequences where, for example, the withdrawal of a country from the eurozone does not disrupt the currency exchange rates between the euro and another currency even while significantly disrupting the exchange rate between the euro and the currency of a country whose risk it was the purpose of the derivative transaction to hedge. In such a case there could be significant volatility to the price of a transaction without actually creating a specified disruption event.

5 Disruption events implicated by a eurozone break-up could include one or more of the following without limitation: section 5.1(d)(i) -- benchmark obligation default; section 5.1(d)(iii), (iv), (xii) or (xiii) – inconvertibility or nontransferability of an “event currency”; section 5.1(d)(viii) – material change of circumstance in an “event jurisdiction” that makes it impossible for a party to perform; and section 5.1(d)(x) or (xi) – price materiality or price source disruption.

Disruption Fallbacks

An analogous set of issues may be posed by the search for appropriate disruption fallbacks for the transaction if a disruption event does occur. The 1998 Definitions specify several fallback positions that parties may select that would control the response to a disruption event. If no fallbacks are specified the 1998 Definitions impose default positions. For example, in the case of the disruption events for general or specific inconvertibility or non-transferability the fallbacks are "local currency substitute" and "settlement postponement" (in that order). For a disruption event of benchmark obligation default the fallbacks are "local asset substitute" and "settlement postponement" (in that order). For a disruption owing to a material change of circumstance the fallback is "no fault termination" of the transaction valuing the transaction as if both parties were affected parties (as defined in section 6 of the 1992 ISDA master agreement). Of course, if the parties to a deliverable transaction did not specify a disruption event there would not be a fallback. In the case of a non-deliverable transaction as to which there was a price disruption, the disruption fallback would be by reference to a calculation agent determination. The applicable fallback could have significant implications for the settlement and the valuation of transactions. For example, a fallback of "local asset substitute" may not be welcome to a counterparty who is concerned at the devaluation of a local currency in relation to the euro.

Selected Issues Arising Under Master Agreements

General

Wholly aside from the mechanisms contemplated by the 1998 Definitions, the provisions of the applicable master agreement itself could be highly relevant to the analysis of how a eurozone break-up may affect the parties to a currency derivative transaction. Even if the parties have elected appropriate disruption fallbacks or if the transaction is not disrupted, the master agreement governs the performance obligations of a party that may be subject to diminished capacity to perform its obligations, as may be the case if a party obligated to deliver euro is domiciled in a country that has left the eurozone and may be subject to legal and practical constraints on its ability to purchase euro with its devalued local currency. In such a case the contractual provisions in the master agreement as modified by the schedule may provide the only definitive source of guidance as to how to deal with the change of circumstances. Although the detailed provisions of the master agreements are beyond the scope of this article, there are several issues that may be particularly relevant to the rights and obligations of parties to a currency derivatives transaction if a country withdraws from the eurozone.

Contractual Currency Elections

Both of the ISDA forms and the IFEMA form contain provisions that require payment or delivery in the contractually agreed currency (the "Contractual Currency"). Section 8(a) of each ISDA form provides that any obligation to make payments thereunder "will not be discharged or satisfied by any tender in any currency other than the Contractual Currency, except to the extent such tender results in the actual receipt by the party to which payment is owed, acting in good faith and using commercially reasonable procedures in converting the currency so tendered into the Contractual Currency, of the full amount in the Contractual Currency of all amounts payable in respect of" the agreement. Section 8.1 of the IFEMA form similarly provides that the receipt or recovery by a party of any amount in respect of an obligation of the other party in a currency other than the Contractual Currency shall discharge such obligation only to the extent that the recipient is able to exchange the currency received or recovered for the amount of Contractual Currency due under the contract "in accordance with normal banking practices." Both the IFEMA form and each of the ISDA forms contain an obligation to make up any shortfall in the Contractual Currency.

Although clear on their face, these provisions contain ambiguities that may become material to the interpretation of the contractual rights and obligations of the parties in some scenarios. For example, it may be argued that the reference to "payment" in section 8.1(a) of each of the ISDA forms would make the provision inapplicable to deliveries of currency in physical settlement of deliverable transactions. Furthermore, where a party to a currency swap transaction is located in a country that has exited the eurozone and that has imposed exchange controls, questions may arise as to whether one party may effectively reduce its contractual obligation by using an exchange rate that is unfavorable to the other side but that complies with the language of the relevant provision of the master agreement. Another set of interpretive questions may arise with respect to the meaning of the term "Contractual Currency" in circumstances where a transaction denominated in euro was arguably intended to be settled by reference to the currency of a particular country.[6]

Termination Events

A currency-related event that affects one party to a transaction could permit the other party to terminate the transaction. However (assuming that the Contractual Currency issue described above does not frustrate performance) the way in which termination events might unfold could be affected by the form of master agreement used.

Illegality

Under each ISDA form and the IFEMA form a termination event for illegality will occur if it becomes unlawful under applicable law for a party to make or receive a payment. Therefore, if an exiting eurozone state implements exchange controls preventing local offices and entities from paying obligations in euro, a local office or entity would be unable to fulfill its payment obligation in euro and a termination event due to illegality could be claimed, with the non-paying party in breach of the agreement. Note that the agreement would be subject to termination upon the implementation of exchange controls, not when payment is due, as it is anticipatory in nature.

However, there are differences among the master agreements that may be material to the ability of a non-affected party to terminate a transaction for illegality. The 2002 ISDA master agreement keys the illegality termination event to the ability to make or receive payments through a specific office that is designated as the office through which the affected party acts. In contrast, the other master agreements relate illegality to the party generally. Therefore, termination for illegality may involve a different analysis in transactions documented under the 2002 ISDA master agreement than for transactions governed by the 1992 ISDA master agreement or the IFEMA form.

There are other differences between the 1992 ISDA master agreement and the 2002 ISDA master agreement that may also be important. For example, under the 1992 ISDA master agreement the parties must endeavor within 30 days to transfer the transaction to another office/affiliate before the transaction can be terminated. By contrast, the 2002 ISDA master agreement imposes a period of only three days before transactions can be terminated. The 1992 ISDA master agreement requires that parties continue to make payments during the period before the date on which transactions are terminated for illegality. On the other hand, the parties do not remain obligated to make such

6 See, e.g., *Lemaire v. Kentucky & Indiana Terminal R. Co.*, 242 F.2d 884 (2d Cir. 1957) (concluding that, under English law, interest accruing "at the rate of four and a half per cent. per annum in like gold coin" on a sterling-denominated bond issued during the gold standard era was payable in British currency rather than the equivalent value of actual gold coins).

payments during the period of illegality prior to termination under the 2002 ISDA master agreement. For these reasons the illegality provision of the 2002 ISDA master agreement may be preferable to a non-affected party than that in the 1992 ISDA master agreement.

Force Majeure

Force majeure is another termination event that may be implicated in a scenario where an exiting member state employs exchange controls that make it practically difficult but not illegal to obtain currency. However, this termination event does not exist in the 1992 ISDA master agreement. Therefore it would in principle be applicable only to transactions documented using the IFEMA form or the 2002 ISDA master agreement.

Solutions to Mitigate Effects of Redenomination

Thinking of what once seemed unthinkable, market participants may wish to take stock of the potential consequences of a eurozone break-up for their currency transactions. To the extent that a party to a currency transaction is concerned with the risk that eurozone dissolution may put its positions out-of-the-money or may create unacceptable performance or counterparty risk, it may seek to take appropriate action. A few possible solutions that could manage the risk of redenomination:

- Conduct an audit of currency derivatives transactions, including type of agreement, nature of documentation, settlement terms and applicable disruption events and disruption fallbacks. Such review may also need to encompass underlying currency and country risks ultimately being hedged or benchmarked.
- Consider the appropriate disruption events that would apply in the case of eurozone dissolution, and/or consider whether to negotiate fallbacks that would apply in the event that a country were to leave the eurozone. For example, consider whether, in contracts providing for physical settlement, whether to provide for cash settlement as an alternative means of settlement, or whether to specify currency terms to apply in the event that the euro ceases to be the legal tender for one or more countries.
- Consider whether the elective provisions of the master agreement governing transactions are optimal. Issues to be analyzed may include which form of master agreement is being used, whether that form is appropriately protective, potential ambiguities that may frustrate the intent of the parties following a currency event, whether the choice of governing law is appropriate and whether the provisions for offices to make or receive payment are adequate.
- Consider how collateral and credit support in an appropriate jurisdiction may be incorporated in transactions to provide adequate assurance of a right to receive payment in full in the Contractual Currency.

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