CLIFFORD CHANCE

Briefing note

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The Eurozone Crisis and Derivatives

The Eurozone crisis continues to dominate the global economic landscape, raising questions among market participants as to the implications for market standard derivatives documentation should a Eurozone member leave the currency union, albeit this remains an unlikely event. This briefing addresses that issue in the context of the 1992 ISDA Master Agreement (Multicurrency – Cross Border) and the 2002 ISDA Master Agreement.

Key issues

When analysing derivatives documentation for potential effects of a Eurozone member's departure from EMU, consider:

- **Jurisdiction**
- **Governing law**
- **Currency of payment provisions**
- **Place of payment**
- **Illegality Termination Event, Events of Default and other documentary provisions**

***Question 1*: I have entered into an ISDA Master Agreement with a private company incorporated in a Eurozone country (my counterparty). I am worried the country (the Departing State) may leave the Eurozone. If the Departing State were to leave and establish its own currency, would I still be entitled, and my counterparty still be obliged, to make payments in Euro?**

Answer: One of the challenges with analysing this set of circumstances is that the manner and legal basis upon which a country might exit from European Monetary Union (EMU) would substantially affect the analysis. There are a number of ways in which it is possible to foresee exit occurring. These range from a European Union (EU) approved withdrawal from the EU and the Eurozone or an approved withdrawal from the Eurozone but not the EU (although there is no mechanism in the EU Treaties for the latter), to a unilateral withdrawal by the Departing State (from one or both) on a non-consensual basis (but which could itself subsequently be approved by EU action). In each case, it is also likely that the Departing State will seek to impose capital and/or exchange controls. Accordingly, a complicated set of legal considerations arises. Moreover, the conflicts of law position would further complicate matters, as would the approach to redenomination adopted in any domestic monetary legislation in the Departing State.

For the sake of simplicity, assume that the Departing State passes a law redenominating all obligations owed by and to its nationals from Euro into a new currency, without EU consensus and over-arching EU legislation recognising the redenomination of debts effected by the Departing State's domestic monetary law (EU Supporting Monetary Legislation). For these purposes, we will not consider any implications arising from the imposition of capital and/or exchange controls.

Still further complexity is layered upon the analysis when looking at derivatives transactions. Why is this? First, derivatives can comprise a multitude of different asset classes (e.g. interest rates, FX, credit, equities, funds, property indices etc) and each has its own set of standard provisions. The International Swaps and Derivatives Association, Inc. (ISDA), for example, has produced not only the 1992 and the 2002 ISDA Master Agreements, but also a range of asset class specific definitions. Second, unlike loans or bonds, derivatives transactions typically provide for two-way payment streams, so it is necessary to consider payments due *to* the counterparty as well as payments due *from* the counterparty. It is worth noting, however, that industry bodies, such as ISDA, may provide guidance and agree with market participants to publish protocols relevant to the issues raised by the redenomination.

To simplify matters therefore, we will assume that the derivatives transactions in question (ISDA transactions) have been entered into under the 1992 or the 2002 ISDA Master Agreement, that they are in the interest rates asset class (e.g. interest rate swaps), that either the 2000 or the 2006 ISDA Definitions have been incorporated by reference into the Confirmations relating to those ISDA transactions, that there is no relevant EU Supporting Monetary Legislation and that no industry protocol(s) have been published. We will briefly consider some of the issues to be aware of in relation to other asset classes towards the end of this briefing.

As a starting point, if you have a 1992 or a 2002 ISDA Master Agreement with:

- an English or New York governing law provision;
- payment obligations in the single European currency; and
- payments to and from the counterparty outside of the Departing State,

and the dispute is heard by an English or a New York court, as the case may be (following the acceptance of jurisdiction), then each of the English and New York courts, as relevant, should hold that the payments are to be made in Euro.

Where any of the above factors is missing the analysis becomes more complex. The variables are discussed in greater detail below:

- **(a) Governing law** – The 1992 and the 2002 ISDA Master Agreements are typically governed by English law or by New York law. While we consider that (on the assumptions stated above) both the English and the New York courts should regard the contract as continuing to require payment in Euro notwithstanding the terms of the Departing State's redenomination legislation, subject to what is said in paragraphs (b) to (d) below, the position may be different if the contract is governed by the law of the Departing State. In that case, the English or the New York courts may be obliged to give effect to the redenomination legislation, although such courts may refuse to give effect to that legislation on the grounds of public policy, for example if it is discriminatory, confiscatory or contrary to treaty obligations.
- **(b) Jurisdiction** – The standard jurisdiction submission provision in an English law governed 1992 or 2002 ISDA Master Agreement gives exclusive jurisdiction to the English courts where the proceedings involve a court in a jurisdiction bound to apply what is now the Brussels I Regulation and non-exclusive jurisdiction to the English courts otherwise (see section 13 of the 1992 or the 2002 ISDA Master Agreement). Where the Agreement is governed by New York law it gives non-exclusive jurisdiction to the New York courts.

In any event, there is always a risk that the counterparty might be able to start proceedings in the courts of the Departing State before proceedings are started in the English or the New York courts.

If the counterparty does start proceedings in the Departing State's courts first (in relation to an ISDA Master Agreement governed by English law), the English courts will be unable to go ahead with proceedings until the Departing State's courts have declined jurisdiction, notwithstanding the exclusive nature of the jurisdiction clause for those courts bound to apply the Brussels I Regulation. The courts of the Departing State should decline jurisdiction (though doing so can take a long time) but, if they found any reason not to do so, they would, in all likelihood, give effect to the Departing State's redenomination legislation, meaning that the counterparty would be able to pay in the new currency and not in Euro. On the assumption that the Departing State remained in the EU, the Brussels I Regulation would oblige English courts to recognise and enforce a judgment of the Departing State's courts, unless to do so would be "manifestly contrary" to English public policy. Therefore, as a practical matter, if there is a dispute you may need to issue proceedings in the English courts as soon as possible.

In relation to an ISDA Master Agreement governed by New York law, the New York courts would not necessarily decline jurisdiction if proceedings are started by the counterparty in the courts of the Departing State given the importance of the public policy issues raised by such a proceeding.

- **(c) Currency of payment** – If any claim relating to the 1992 or the 2002 ISDA Master Agreement and the related ISDA transaction(s) were to come before the English or the New York courts, a key question would be whether the contractual intention was for the currency of payment to be (i) the single European currency or (ii) the currency of the Departing State from time to time. This would be determined by reference to the definition of Euro in the 2000 or 2006 ISDA Definitions in the context of the specific transaction (see the text box "ISDA Definition of Euro").

We think it is likely that the English and the New York courts would interpret the ISDA definition of Euro to mean the single European currency established under EMU, rather than the currency of the Departing State from time to time (so that it would not be the law of the Departing State which supplies the *lex monetae* for the purposes of the Agreement). However, we do not rule out the possibility that a different interpretation could be given if other factors are present, for example if an ISDA transaction is designed to hedge risk arising in the Departing State and payment is required to be made in the Departing State. What is certain is that both the English and the New York courts would be aware that any decision they reached as to the proper interpretation of the ISDA definition of Euro would impact not only the particular ISDA transaction under consideration but more generally the over-the-counter derivatives market globally.

We also think it is unlikely that an English or a New York court would accept the argument that the ISDA definition of Euro does not apply to the currency of the remaining Eurozone member states where a state that has adopted the Euro ceases to use it as its currency, in particular where the Departing State is using a new currency in contravention of its Treaty obligations and where the remaining Eurozone states can be regarded as the states that adopt and use the Euro "in accordance with the Treaty".

In addition, if the Euro is continuing as the single European currency, we think it unlikely that an English or a New York court would find that an ISDA transaction requiring payments in Euro has been frustrated. There is a high bar to a finding of frustration. The fact that one state has ceased to use the Euro does not make performance in Euro impossible and should not be regarded as rendering performance in Euro a radically different thing than that which was undertaken in the contract. Similarly, it should not be regarded as a Force Majeure Event under section 5(b)(ii) of the 2002 ISDA Master Agreement as it does not, in itself, prevent performance in Euro or make it impossible or impracticable to make Euro payments.

It might be more difficult to conclude that references to the Euro mean the single European currency established under EMU if multiple states departed from the Euro because at a certain point a court might be unwilling to require payment in Euro on the basis that the currency would arguably no longer be the same currency as was originally contemplated by the contracting parties. However, it seems unlikely that there would be multiple Departing States without consequential treaty changes and accompanying EU legislation addressing continuity of contract issues.

- **(d) Place of payment** – As a matter of English law, the place of payment could be relevant for a number of reasons.
  - First, it may assist in determining whether the parties intended payment to be made in the currency for the time being of the Departing

ISDA Definition of Euro

"***Euro.*** *"Euro", "euro", "€" and "EUR" each means the lawful currency of the member states of the European Union that adopt the single currency in accordance with the EC Treaty.*"

- Extract from the 2000 ISDA Definitions and the 2006 ISDA Definitions

"***EC Treaty.*** *"EC Treaty" means the Treaty establishing the European Community (signed in Rome on March 25, 1957), as amended by the Treaty on European Union (signed in Maastricht 3 on February 7, 1992) and as amended by the Treaty of Amsterdam (signed in Amsterdam on October 2, 1997).*"

- Extract from the 2000 ISDA Definitions

"***EC Treaty.*** *"EC Treaty" means the Treaty establishing the European Community (signed in Rome on March 25, 1957), as amended by the Treaty on European Union (signed in Maastricht 3 on February 7, 1992), the Treaty of Amsterdam (signed in Amsterdam on October 2, 1997) and the Treaty of Nice (signed in Nice on February 26, 2001).*"

- Extract from the 2006 ISDA Definitions

State or in the single European currency if there is no clear definition of Euro. English law has a presumption, albeit fairly weak and certainly rebuttable, that the currency of payment will be that of the place of payment. As a result, if payment is required in the Departing State, then there is a presumption that the currency of payment is that of the Departing State. As we discussed in (c) above, where the 2000 or the 2006 ISDA Definitions are used, the ISDA definition of Euro will apply and be effective so as to rebut this presumption.

- The second effect of the place of payment is more significant. Suppose a dispute comes before the English courts, suppose the agreement is governed by English law and suppose there is a currency definition that is clear in pointing to the single European currency rather than the Departing State's currency for the time being. Despite these three positive factors, if the place of payment is in the Departing State, the English courts could still give priority to the Departing State's law. This is because article 9(3) of the Rome I Regulation states that a court may give effect to the overriding mandatory laws of the place where an obligation is to be performed if those overriding mandatory laws render performance unlawful. It is not enough that a currency is re-denominated, but rather payment in Euro in the Departing State would have to be unlawful under the Departing State's laws. Even then, the court hearing the case has a discretion as to whether to give effect to the Departing State's laws - it is not obliged to do so - but the expectation should probably be that a court will be reluctant to order anyone to do something that might be, for example, a criminal offence in the Departing State. Article 12(2) of the Rome I Regulation also requires a court to have regard to the law of the place of performance in relation to the manner of performance and the steps to be taken in the event of defective performance. In relation to a unilateral non-consensual departure from the Euro, it may be possible to argue that it is inconsistent with the EU Treaties (to which the UK is a party) or is in some way discriminatory or confiscatory, and that accordingly the Departing State's new monetary law is contrary to English public policy so that the English courts should not apply that law.

- It is worth noting that there is a legal difference between agreements made on or after 17 December 2009 and those made earlier. The Rome I Regulation only applies to agreements on or after that date, although in practice it probably makes little difference since English common law rules on illegality in the place of performance are, if anything, more severe and might apply notwithstanding Article 9(3) of the Rome I Regulation.

- Under New York law, the place of payment affects the application of the Act of State Doctrine. The Act of State Doctrine requires that the acts of foreign sovereigns taken within their own jurisdiction shall be deemed valid. Accordingly, if the contract were by its terms payable in the Departing State, a New York court might apply the legislation of the Departing State even if the contract is otherwise governed by New York law.

- Under the 1992 and the 2002 ISDA Master Agreements, a party is allowed to change its account for receiving a payment by giving 5 local business days' notice, unless the other party gives timely notice of a "reasonable objection" to such change. So:

  - in relation to payments owed by the counterparty to you under the ISDA transaction: if the account you have designated for your receipt of payments is in the jurisdiction of the Departing State, you could consider changing it as described above;

  - in relation to payments owed by you to the counterparty under the ISDA transaction: if the account the counterparty has designated for its receipt of payments is in the jurisdiction of the Departing State, there is little you can do about this unless the counterparty is willing to change that account as described above; however, if that account is in another jurisdiction, and the counterparty notifies you of its intention to change that account to one in the jurisdiction of a Eurozone member you are concerned about, you might be able to prevent this change if you could successfully argue that you were raising a "reasonable objection".

***Question 2:* Neither I nor my counterparty are incorporated or acting from an office in the Departing State. Would the Departing State's exit from the Eurozone affect my right to receive, or obligation to make, payments in Euro?**

Answer: Very unlikely. On the basis of the assumptions outlined in Question 1 above, a similar analysis would apply save that the issues relating to jurisdiction and place of payment are less likely to be relevant. An English court or a New York court will interpret payment obligations to be performed outside the Departing State, and, as discussed above, should hold that obligations expressed using the ISDA definition of Euro will continue to be obligations in the single European currency.

***Question 3:* I have an ISDA transaction with a private company incorporated in a Departing State which provides for payments in Euro. Would the Departing State's exit from the Eurozone trigger a Termination Event or an Event of Default under the 1992 or the 2002 ISDA Master Agreement?**

Answer: The 1992 and the 2002 ISDA Master Agreements do not include the withdrawal of a Eurozone member from the Euro as a specific Termination Event or Event of Default. However, depending on the circumstances, other Termination Events or Events of Default could well be relevant – including, for example, the Termination Event for Illegality (considered in Questions 4 to 9 below) or an Event of Default for Failure to Pay (considered in Question 10 below).

***Question 4:* When might an Illegality Termination Event apply?**

Answer: If, due to a change in applicable law (for example, the imposition of capital and/or exchange controls by the Departing State), it becomes unlawful for a party (the Affected Party) to meet its obligations to make or receive payments under the ISDA Master Agreement, a Termination Event for Illegality might arise (section 5(b)(i) – see the text box "Illegality"). If the unlawfulness is the result of the party's failure to comply with its obligation to obtain authorisations, there would be no Illegality, but an Event of Default might arise instead (we discuss this further in Question 16 below).

On the occurrence of an Illegality, the Affected Party is required to give notice promptly to the other party (section 6(b)(i)). Beyond this, the 1992 and the 2002 ISDA Master Agreements take differing approaches

Illegality

*"**Illegality**. Due to the adoption of, or any change in, any applicable law after the date on which a Transaction is entered into, or due to the promulgation of, or any change in, the interpretation by any court, tribunal or regulatory authority with competent jurisdiction of any applicable law after such date, it becomes unlawful (other than as a result of a breach by the party of Section 4(b)) for such party (which will be the Affected Party): —*

(1) to perform any absolute or contingent obligation to make a payment or delivery or to receive a payment or delivery in respect of such Transaction or to comply with any other material provision of this Agreement relating to such Transaction; or

(2) to perform, or for any Credit Support Provider of such party to perform, any contingent or other obligation which the party (or such Credit Support Provider) has under any Credit Support Document relating to such Transaction;"

- Extract from the 1992 ISDA Master Agreement

*"**Illegality**. After giving effect to any applicable provision, disruption fallback or remedy specified in, or pursuant to, the relevant Confirmation or elsewhere in this Agreement, due to an event or circumstance (other than any action taken by a party or, if applicable, any Credit Support Provider of such party) occurring after a Transaction is entered into, it becomes unlawful under any applicable law (including without limitation the laws of any country in which payment, delivery or compliance is required by either party or any Credit Support Provider, as the case may be), on any day, or it would be unlawful if the relevant payment, delivery or compliance were required on that day (in each case, other than as a result of a breach by the party of Section 4(b)):—*

(1) for the Office through which such party (which will be the Affected Party) makes and receives payments or deliveries with respect to such Transaction to perform any absolute or contingent obligation to make a payment or delivery in respect of such Transaction, to receive a payment or delivery in respect of such Transaction or to comply with any other material provision of this Agreement relating to such Transaction; or

(2) for such party or any Credit Support Provider of such party (which will be the Affected Party) to perform any absolute or contingent obligation to make a payment or delivery which such party or Credit Support Provider has under any Credit Support Document relating to such Transaction, to receive a payment or delivery under such Credit Support Document or to comply with any other material provision of such Credit Support Document;"

- Extract from the 2002 ISDA Master Agreement to Illegality.

Under the 1992 ISDA Master Agreement:

- Where there is one Affected Party, that party must use "all reasonable efforts" to transfer the affected ISDA transactions to another office or an affiliate within 20 days of the Illegality notice in order to avoid the Illegality. If it is not able to do so, the non-Affected Party may make this transfer within 30 days of the Illegality notice (section 6(b)(ii)). If a transfer has not been effected within 30 days of the Illegality notice, either party may terminate the affected ISDA transactions by notice to the other (section 6(b)(iv)(1)).
- Where there are two Affected Parties, they are required to use "all reasonable efforts" to reach agreement on action to avoid the Illegality within 30 days of the Illegality notice (section 6(b)(iii)). If the parties do not reach agreement within that period, either party may terminate the affected ISDA transactions by notice to the other (section 6(b)(iv)(1)).

Under the 2002 ISDA Master Agreement:

- After a waiting period of 3 local business days following the occurrence of the Illegality, either party may terminate the affected ISDA transactions by giving not more than 20 days' notice to the other (section 6(b)(iv)(2)).

***Question 5*: Before the affected ISDA transactions can be terminated, would the non-Affected Party have to keep making payments to the Affected Party?**

Answer: Under a 2002 ISDA Master Agreement, no. During the 3 local business days' waiting period after the occurrence of the Illegality, both parties' obligations under the affected ISDA transactions are deferred. The obligations may, however, be revived at the end of the waiting period if neither party elects to terminate the affected ISDA transactions (section 5(d)). There is no equivalent provision in the 1992 ISDA Master Agreement, however, so it would seem that the non-Affected Party's obligations would continue until the Affected Transactions were terminated (see the further discussion of section 2(a)(iii) in relation to non-payment below), unless one could successfully argue that the circumstances gave rise to a frustration as a matter of English or New York law, as the case may be, and did not fall within the definition of Illegality (see Question 1 part (c) above for some general comments on the frustration argument).

***Question 6*: How is the amount payable on termination for Illegality calculated?**

Answer: Under the 1992 ISDA Master Agreement, if there is only one Affected Party, the amount payable on a termination of the affected ISDA transactions as a result of an Illegality will be calculated in the same manner as if those ISDA transactions were being terminated as a result of an Event of Default in respect of the Affected Party (section 6(e)(ii)(1)). However, if there are two Affected Parties, the calculation will be made differently - each party makes its own calculation and the amount payable will be based on the mid-point between the two calculations (section 6(e)(ii)(2)).

Under the 2002 ISDA Master Agreement, in determining the close-out amount following a termination as a result of an Illegality, whether one or two parties is affected by the Illegality, mid-market quotations or mid-market values are used (section 6(e)(ii)(3)).

***Question 7*: Can both parties be Affected Parties for the purposes of Illegality?**

Answer: Yes. However, where the place of payment is outside the Departing State and one or both parties are outside the Departing State, this is unlikely. It seems unlikely that the legislation passed by the Departing State would purport to have extraterritorial effect prohibiting the payment or receipt of Euro amounts outside the Departing State by a party incorporated or based outside the Departing State.

***Question 8*: Can the same event lead to an Illegality and an Event of Default?**

Answer: Under the 1992 ISDA Master Agreement, if an event would give rise to an Event of Default as well as an Illegality, it will be treated as an Illegality (section 5(c)).

Under the 2002 ISDA Master Agreement, if an event would give rise to an Event of Default that is a failure to pay or deliver, a failure to comply with any other material provision of the 2002 ISDA Master Agreement or a Credit Support Document, or a Force Majeure Event, as well as an Illegality, it will be treated as an Illegality (section 5(c)).

***Question 9*: What is an applicable law for the purposes of Illegality?**

Answer: There is no definition of what is an applicable law for the purposes of the definition of Illegality, except that the 2002 ISDA Master

Agreement states that it includes the laws of a country in which payment, delivery or compliance is required. However, it clearly covers the laws of countries other than the governing law of the Agreement, including potentially laws that have extraterritorial application. There may be issues as to whether laws of a Member State that are contrary to EU requirements can be regarded as applicable if the result is that the particular requirement would not be regarded as binding on the party in question under EU law.

***Question 10*: Where there is no Illegality and the payment obligations are denominated in Euro, but the counterparty makes payment to me in the new currency of the Departing State, would this constitute a failure to pay or deliver Event of Default under section 5(a)(i) of the 1992 or the 2002 ISDA Master Agreement?**

Answer: Yes, after the expiry of the relevant grace period (three Business Days under the 1992 ISDA Master Agreement, one Business Day under the 2002 ISDA Master Agreement), unless the payment in the new currency (or any other currency) results in your actual receipt (acting in good faith and using commercially reasonable procedures to convert the new currency tendered into Euro) of the full amount due in Euro, in which case the counterparty's payment obligations would be satisfied (section 8(a) of the 1992 and the 2002 ISDA Master Agreements). If the counterparty is in financial difficulties occasioned by a withdrawal of credit or other negative consequences triggered by the redenomination, it might not be able to make any or full payment regardless of currency. This might also mean that the bankruptcy Event of Default could apply. It is worth bearing in mind that section 2(a)(iii) of the 1992 and of the 2002 ISDA Master Agreement makes the payment/delivery obligations of a party subject to the condition precedent that no Event of Default or Potential Event of Default (note that this would not cover an Illegality) with respect to the other party has occurred and is continuing – however section 2(a)(iii) is currently the subject of litigation in *Lomas v JFB Firth Rixson* and a decision from the Court of Appeal is awaited.

***Question 11*: If the counterparty defaults on any other obligations, will this constitute an Event of Default?**

Answer: If the counterparty defaults on any other obligations then, to the extent that the "Cross Default" Event of Default is applicable to the counterparty under the 1992 or the 2002 ISDA Master Agreement (subject to the definitions of Specified Indebtedness and Threshold Amount specified by the parties in the Schedule to the ISDA Master Agreement), this may result in a "Cross Default" Event of Default under section 5(a)(vi).

***Question 12*: I have obtained a judgment from an English or a New York court. Can I enforce it against my counterparty's assets located in the Departing State?**

Answer: Obtaining an English or a New York court judgment against the counterparty is one thing. Enforcing against assets in a Departing State is something else. In many cases, it is likely that the counterparty will only have substantial operations and assets in the Departing State. In the ordinary course, a creditor would enforce against those assets by asking the courts in the Departing State to enforce the English or New York judgment. In the case of a Eurozone exit, the Departing State's courts would almost certainly be required to give effect to the Departing State's redenomination legislation and would, therefore, be unlikely to recognise, or enforce, an English or a New York judgment for Euro denominated debt against the counterparty. As a consequence enforcement against assets located in the Departing State would be difficult and swap market participants may want to consider the extent of their counterparties' assets in other jurisdictions.

***Question 13:* Does the currency indemnity at section 8(b) of the 1992 and the 2002 ISDA Master Agreements help?**

Answer: The currency indemnity at section 8(b) of the 1992 and the 2002 ISDA Master Agreements is included to cover potential currency losses of a party in relation to a judgment of a court which is given in a currency other than the contractual currency. This indemnity may be relevant where a judgment is given in the new domestic currency but the payment provisions remain denominated in Euro. However, there are some doubts as to the effectiveness of these indemnities generally.

***Question 14*: My counterparty's obligations under our ISDA transaction are guaranteed by a guarantor in the Departing State. Would the Departing State's exit from the Eurozone impact the guarantee obligations?**

Answer: The effect on the guarantee would be a matter for the governing law of the guarantee, and the points referred to in answer to the previous questions would also be relevant here. It would be important whether the intention was that the guarantor's Euro payment obligations were to be in Euro or in the national currency from time to time of the guarantor's (or counterparty's) jurisdiction of incorporation. As a practical matter, where the guarantor is located inside the Departing State, the guarantor may find it difficult to make Euro payments if its revenues are in the redenominated currency.

In relation to your 1992 and 2002 ISDA Master Agreements with the counterparty, if the guarantor is a credit support provider in respect of the counterparty, you would also need to consider whether this would result in the occurrence of any Termination Events or Events of Default. For example, if, due to a change in applicable law, it becomes unlawful for the credit support provider to perform its obligations under any credit support document, a Termination Event for Illegality would result.

The Illegality provisions in the 1992 and the 2002 ISDA Master Agreements differ from those described in Questions 4 to 9 above where the Illegality relates to obligations under credit support documentation. In particular, where the Illegality relates to the performance by a party or its credit support provider of obligations under a credit support document: i) under the 1992 ISDA Master Agreement, either party may terminate the affected ISDA transactions by notice to the other, without the requirement for prior notice and an opportunity to transfer (section 6(b)(iv)(2)); and ii) under the 2002 ISDA Master Agreement, the waiting period is 3 local business days unless the relevant payment, delivery or compliance is actually required on the relevant day (in which case no waiting period will apply) and, on the expiry of the waiting period, the Affected Party can only terminate if the other party terminates some but not all affected ISDA transactions (section 6(b)(iv)(2)(B)).

Question 15: What if my counterparty is the Departing State itself?

Answer: For a sovereign obligor, in addition to looking at English or New York governing law and submission to the jurisdiction of the English or the New York courts, it would also be important to consider whether there is a waiver of immunity. Sovereigns are likely to benefit from potential immunity relating to their assets and therefore no enforcement measures may, in general, be taken against a sovereign's assets unless there is an express waiver of immunity. Both the 1992 and the 2002 ISDA Master Agreements contain such a provision (section 13(d)), but, even so, it might remain difficult in practice to enforce a judgment against the Departing State in the Departing State.

***Question 16*: Are there any other ISDA documentation points I should be thinking about?**

Answer: Yes, including:

- **Payment Netting:** If some Euro amounts were redenominated into the new currency while other Euro amounts were not, the parties would lose the benefit of payment netting under section 2(c) of the 1992 and the 2002 ISDA Master Agreements.
- **Maintenance of authorisation:** To the extent that the redenomination legislation or associated capital and/or exchange controls legislation requires a party to an ISDA transaction to obtain any governmental or other consents in order to perform its obligations, that party is required to use "all reasonable efforts" to obtain those consents under section 4(b) of the 1992 and the 2002 ISDA Master Agreements. There is ambiguity as to whether all reasonable efforts is the same as best efforts or whether it represents an obligation lying between reasonable and best efforts but, whether or not that is the case, English courts have interpreted these obligations as not requiring a party to sacrifice its own commercial interests. The New York courts have interpreted reasonable efforts to be less stringent than the best efforts standard. In practice, therefore, this may prove not to be too onerous an obligation to discharge. A party's failure to comply with this obligation would, however, result in an Event of Default (after the expiry of the applicable grace period) under section 5(a)(ii) of the 1992 and the 2002 ISDA Master Agreements.
- **Bank holidays:** The Departing State may declare extended bank holidays to facilitate the changeover to the new currency. This will affect the definition of local business day which will be relevant for making payments or deliveries in the Departing State and will also affect the ability to serve notices (including notices of termination) on counterparties in the Departing State (although the 2002 ISDA Master Agreement seeks to address this issue in the definition of the waiting period and local business

day relating to the giving of notices in relation to Illegality).

- **Bankruptcy laws:** Parties in the Departing State may be subject to mismatches between the currency denomination of assets and liabilities, leading to bankruptcy or insolvency proceedings. The Departing State may have or adopt special laws to manage these, which could affect netting and might result in claims being converted (for the purposes of proving claims in bankruptcy) at an unfavourable exchange rate.
- **Impact on other definitions:** To the extent that references in any ISDA transaction to Euro are determined by the courts to be references to the new currency of the Departing State, consideration will need to be given to how other ISDA definitions, particularly those in the ISDA Definitions that refer to Euro, should be interpreted (for example, interest rates indices). If a number of member states depart from the Euro, a party might seek to argue that the contract is frustrated where contractual obligations are to be determined by reference to Euro-based indices or rates because such indices and rates are no longer the same as originally contemplated by the contracting parties.
- **ISDA credit support documents:** Looking first at cash collateral, it is likely that a party's obligations to deliver cash in Euro under the terms of any ISDA credit support documentation will be subject to the analysis outlined above as if the delivery obligations were payment obligations (noting that credit support obligations often have separate account details for settlement than for other ISDA transactions). In relation to non-cash collateral denominated in Euro (for example, bonds issued by the Departing State), the analysis could be more complex as you would need to consider the effect of the redenomination on the assets themselves before construing your documentation. A few particular points to watch out for:
  - *Eligible* Collateral: under the ISDA credit support documentation the redenomination legislation passed by the Departing State might cause an asset that previously satisfied the definition of Eligible Credit Support to fall outside this definition post redenomination. This may require parties to replace the ineligible collateral; and
  - *Equivalent Collateral*: under the ISDA Credit Support Annex (English law) a party is required to return "Equivalent Credit Support". It could be argued that posted collateral which falls within the class of obligations to be redenominated under any applicable national redenomination legislation would no longer be equivalent to the collateral that was originally posted. It is, however, unlikely that a court would follow such an argument as it is difficult to give the return of collateral obligation any other meaning than the return of the posted collateral in its redenominated form.

  The discussion in Questions 4 to 11 above in relation to the possible occurrence of Termination Events (for example, Illegality) or Events of Default in connection with the obligations of a party or its credit support provider under credit support documentation will also be relevant.

***Question 17*: I also have FX/equity/credit derivatives trades outstanding under a 1992 or a 2002 ISDA Master Agreement with a counterparty in the Departing State. How does the analysis above change and what else might I need to think about?**

Answer: You will need to apply the analysis above to those other ISDA transactions and their documentation. We set out below some additional pointers on FX, equity and credit derivatives documentation:

- **FX derivatives:** The 1998 ISDA FX and Currency Option Definitions specifically provide for disruption fallbacks relating to non-transferability, inconvertibility and other disruption events which, if applicable, should apply in priority to the Illegality provisions in the 1992 ISDA Master Agreement and would apply in priority to the Illegality provisions in the 2002 ISDA Master Agreement, for the relevant ISDA FX derivative transactions (it is more certain in the 2002 ISDA Master Agreement as an Illegality only arises "after giving effect to any applicable provisions, disruption fallback or remedy specified in, or pursuant to, the relevant Confirmation").
- **Equity derivatives:** A number of extraordinary events, including

additional disruption events (such as Change in Law, Hedging Disruption and Loss of Stock Borrow), are set out in the 2002 and 2011 ISDA Equity Derivatives Definitions which, if applicable, should apply in priority to the Illegality provisions in the 1992 ISDA Master Agreement and would apply in priority to the Illegality provisions in the 2002 ISDA Master Agreement, for the relevant ISDA Equity derivatives transactions.

- **Credit derivatives:** The redenomination and any related capital and/or exchange controls legislation will need to be considered to determine whether they have directly or indirectly given rise to a credit event under any credit derivatives transaction. Note in particular that, under the 2003 ISDA Credit Derivatives Definitions, a "restructuring" credit event would not occur where the new currency of the Departing State is that of a G7 country or any AAA-rated OECD member country.

***Question 18*: For new deals, what should I be putting in my ISDA transaction documentation?**

Answer: You need to ensure that you have chosen governing law and submission to jurisdiction provisions that are satisfactory to you. A definition of Euro which makes it clear that the payment obligations are in the single European currency and not the currency from time to time of the obligor's jurisdiction of incorporation is also important. In addition, consider designating accounts which are outside the jurisdiction of the Eurozone member you are concerned about for the receipt of payments. If entering into a new ISDA Master Agreement it may be advisable to enter into the 2002 ISDA Master Agreement as the position regarding Illegality is more developed (e.g. deferral of payments on Illegality, you can terminate for Illegality quicker than under the 1992 ISDA Master Agreement and the interaction between Illegality and other disruption events is clearer). If you have a 1992 ISDA Master Agreement, you might want to consider updating the provisions relating to Illegality, to bring this more in line with the position under the 2002 ISDA Master Agreement. Whether you want to include extra credit protection, for example an express default provision for redenomination, would depend on the circumstances of the transaction. It is also likely that ISDA will take a lead in forming a consensus as to recommended future changes to documentation, if any.

***Question 19*: Are there any other steps I should take?**

Answer: The essential things will be to:

- establish where you have ISDA transactions which are potentially affected;
- locate your 1992 and 2002 ISDA Master Agreements (including Schedules, Confirmations and all other relevant documentation (including any amendments (bilateral or by protocol adherence), credit support, guarantees, security etc.);
- establish what elections have been made in the Confirmations for those ISDA transactions in relation to disruption events etc.; and
- analyse how robustly the documentation deals with the issues discussed above, since "forewarned is forearmed" and you will be better placed to act rapidly if circumstances demand.

***Question 20*: If my ISDA *transaction* satisfies the conditions as to governing law, submission to jurisdiction, currency and place of payment so that (absent any EU Supporting Monetary Legislation) it is likely that an English or a New York court would give a Euro denominated judgment on its terms, notwithstanding a currency redenomination by a Departing State, is that an end to my concerns?**

Answer: Unfortunately not. Enforcement of any judgment against assets within the Departing State could be a problem. In addition, overriding EU legislation could possibly impact on the analysis in respect of any assets the counterparty may have outside the Departing State but within the EU. Additionally, receipt of payments, even if the counterparty was apparently able and willing to pay, could be blocked or delayed by the capital and/or exchange controls legislation which would be likely to be implemented alongside any currency redenomination. Of course the fundamental difficulty with achieving repayment would relate to whether, given the economic circumstances, a counterparty actually has sufficient resources to pay in whatever currency and indeed whether it is insolvent. Therefore you may have done your best to preserve your position, but achieving actual repayment in volatile and uncertain times could still be difficult.

The wider context

The above gives a flavour of some of the currency issues to be considered in relation to the Eurozone crisis in the context of derivatives. There are likely to be many more questions and concerns regarding its impact on derivatives documentation. As with any hypothetical situation, it is difficult to foresee how a Eurozone exit would be implemented from a legal perspective, and there are many political, economic and practical barriers standing in its way. There is no existing mechanism for a Eurozone member to depart from the single European currency under the EU Treaties and therefore a Departing State would either be exiting on a non-consensual basis or on a consensual basis with the support of other Eurozone member states pursuant to a treaty or other legal framework which does not currently exist but within the EU institutional framework. The manner of implementing any exit route would have substantial implications in relation to the analysis as to the legal consequences on contractual arrangements, especially in the context of any conflicts of law analysis. The accompanying economic difficulties would give rise to severe and untested eventualities. However, understanding the applicable contractual framework for financing and derivatives transactions provides greater certainty at a time of market turmoil.

20 Questions:

- Question 1: I have entered into an ISDA Master Agreement with a private company incorporated in a Eurozone country (my counterparty). I am worried the country (the Departing State) may leave the Eurozone. If the Departing State were to leave and establish its own currency, would I still be entitled, and my counterparty still be obliged, to make payments in Euro?
- Question 2: Neither I nor my counterparty are incorporated in or acting from an office in the Departing State. Would the Departing State's exit from the Eurozone affect my right to receive, or obligation to make, payments in Euro?
- Question 3: I have an ISDA transaction with a private company incorporated in a Departing State which provides for payments in Euro. Would the Departing State's exit from the Eurozone trigger a Termination Event or Event of Default under the 1992 or the 2002 ISDA Master Agreement?
- Question 4: When might an Illegality Termination Event apply?
- Question 5: Before the affected ISDA transactions can be terminated, would the non-Affected Party have to keep making payments to the Affected Party?
- Question 6: How is the amount payable on termination for Illegality calculated?
- Question 7: Can both parties be Affected Parties for the purposes of Illegality?
- Question 8: Can the same event lead to an Illegality and an Event of Default?
- Question 9: What is an applicable law for the purposes of Illegality?
- Question 10: Where there is no Illegality and the payment obligations are denominated in Euro, but the counterparty makes payment to me in the new currency of the Departing State, would this constitute a failure to pay or deliver Event of Default under section 5(a)(i) of the 1992 or the 2002 ISDA Master Agreement?
- Question 11: If the counterparty defaults on any other obligations, will this constitute an Event of Default?
- Question 12: I have obtained a judgment from an English or a New York court. Can I enforce it against my counterparty's assets located in the Departing State?
- Question 13: Does the currency indemnity at section 8(b) of the 1992 and the 2002 ISDA Master Agreement help?
- Question 14: My counterparty's obligations under our ISDA transaction are guaranteed by a guarantor in the Departing State. Would the Departing State's exit from the Eurozone impact the guarantee obligations?
- Question 15: What if my counterparty is the Departing State itself?
- Question 16: Are there any other ISDA documentation points I should be thinking about?
- Question 17: I also have FX/equity/credit derivatives trades outstanding under a 1992 or a 2002 ISDA Master Agreement with a counterparty in the Departing State. How does the analysis above change and what else might I need to think about?
- Question 18: For new deals, what should I be putting in my ISDA transaction documentation?
- Question 19: Are there any other steps I should take?
- Question 20: If my ISDA transaction satisfies the conditions as to governing law, submission to jurisdiction, currency and place of payment so that (absent any EU Supporting Monetary Legislation) it is likely that an English or a New York court would give a Euro denominated judgment on its terms, notwithstanding a currency redenomination by a Departing State, is that an end to my concerns?

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