New York Law Journal

WWW.NYLJ.COM

An ALM Publication

VOLUME 247—NO. 65

THURSDAY, APRIL 5, 2012

SECURED TRANSACTIONS

The Euro Crisis: Implications For Loan Agreements

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However challenging the Great Recession has been in the United States, it has ravaged the economies of several of the countries that use the euro as their common currency (the Eurozone).[1] Notwithstanding Greece's bond restructuring last month, the possibility remains that one or more countries (a Departing Country) might cease using the euro by leaving the Economic and Monetary Union (EMU) and the European Union (EU). Although projecting how a Eurozone member's departure might occur is difficult,[2] the potential implications of such an event on existing and new credit facilities have been discussed extensively in Europe in relation to the Loan Market Association's standard loan documentation.

The topic, however, has received little coverage in the United States. Today, we examine several issues lenders may face under New York law-governed credit facilities that include euro-denominated tranches to borrowers organized or located in a Departing Country, as well as relevant protective measures lenders may wish to consider when underwriting new or, where feasible, amending existing loan arrangements.[3]

Redenomination and Payment

If a country voluntarily withdraws or is forcibly ousted from the EMU and/or the EU, that Departing Country will need to establish a new currency (or more likely re-establish its pre-euro currency), and presumably will adopt legislation redenominating all debts owed by its nationals from euros into the new currency at a fixed exchange rate. The Departing Country would likely also impose capital and/or exchange controls that ban or restrict the amount of foreign currency or local currency that is allowed to be traded or purchased.

If borrowers are organized or located in (or have substantial operations or subsidiaries in) a Departing Country, the question arises whether their euro-denominated borrowings will remain payable in euros or will be redenominated into the new currency. How the Departing Country's redenomination affects those borrowings under New York law depends primarily on four factors.

Governing Law and Jurisdiction Clause. The threshold issue, of course, is whether New York law applies. Euro-denominated loan tranches typically are part of larger credit facilities that are syndicated rather than bilateral. As we have noted often in this space, New York law has become the law of choice for syndicated lending facilities in both domestic and many cross-border deals. Most loan market participants choose New York law to govern their syndicated credit facilities even when none of the parties to the transaction have a nexus with New York. As long as the parties have also stipulated the New York state and U.S. federal courts sitting in New York as the venue for hearing disputes related to the loan documents, the designated state and (if diversity and amount in controversy requirements are satisfied) federal courts in New York have authority to take jurisdiction of, and apply New York law to, a case adjudicating the effect of a Departing Country's redenomination legislation on the borrower's agreement to make its loan payments in euros.[4]

Statutory Guidance. Title 16 of New York's General Obligations Law, entitled "Continuity of Contract," was enacted in 1997 to address some of the issues anticipated to arise from the then-pending adoption of the euro.[5] The provision dictates that if the subject or medium of payment of a contract is a currency that has been replaced by the euro, the euro is a commercially reasonable substitute and substantial equivalent that may either be used in determining the value of such currency or be tendered at the conversion rate specified in the regulations adopted by the EU. It also provides that the euro's introduction does not excuse performance under, or authorize any party unilaterally to modify or terminate, a contract.

Title 16 applies, however, only to the euro's *adoption*. Neither it nor any other existing or pending legislation in New York deals with the *elimination* of the euro in any Eurozone country. A new continuity of contract statute would presumably occupy the field and, like Title 16, specify New York's view on the principal legal issues discussed herein. In its absence, however, one must consider how those issues might be resolved under other statutes and applicable common law principles.

Currency of Payment. Where the loan agreement is governed by New York law and subject to the jurisdiction of the New York courts, the stated currency in which a loan obligation must be repaid is the determining factor of whether the loan will continue to be payable in euros or will be redenominated in the Departing Country's new currency. If the loan agreement requires payment in euros, and defines "euro" as the single Eurozone currency or otherwise shows clear intent of such meaning, the borrower's obligation to repay the loan in euros should be upheld by New York courts.[6] If the loan agreement is unclear or refers to the currency from time to time constituting the Departing Country's legal tender, however, New

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York courts could (depending on other factors, such as the place of payment) give effect to the redenomination.

Place of Payment. Under New York law, the place of payment of the loan obligations may trigger application of the "Act of State" doctrine. This doctrine, which is based on the U.S. Executive Branch's exclusive authority to conduct foreign affairs, limits the power of U.S. courts to render judgments on the validity of actions by foreign states within their own borders.[7] Thus, if the loan agreement requires the loan obligations to be paid in the Departing Country, a New York court might apply the Departing Country's redenomination legislation and exchange control regulations to the debt even though the agreement is governed by New York law and specifies the euro as the exclusive currency for payment.

Nevertheless, as long as the loan agreement is governed by New York law, chooses New York venue and clearly provides for loan payments to be made in euros outside the Departing Country, New York courts should rule that the borrower remains obligated to pay its loan obligations in euros notwithstanding any redenomination legislation or exchange controls adopted by the Departing Country.[8] A similar analysis would apply to New York law guarantees of payment obligations under a euro-tranche facility where the guarantor is located in a Departing Country.

Enforcement of Judgments

In cases based on obligations denominated in a foreign currency, New York applies the so-called "judgment day" rule—the court must render judgment in the foreign currency, which is then converted into U.S. dollars at the prevailing exchange rate on the date the judgment is entered.[9] In the situation discussed above, therefore, a New York court should enter a judgment for the debt in euros.

Nevertheless, although lenders should be able to obtain a euro-denominated judgment in New York, enforcing it against a borrower's (or guarantor's) assets in the Departing Country may be problematic. A creditor seeking to assert a New York euro-denominated judgment against assets of a debtor in a foreign jurisdiction ordinarily will ask the courts in that jurisdiction to enforce the judgment. Following a withdrawal from the Eurozone, one can expect that the Departing Country's courts will apply that country's redenomination legislation and not give effect to the New York court's euro-denominated judgment. The Departing Country's courts may well enter a judgment in the new national currency by converting the euro-denominated judgment into the new currency at the exchange rate set by the Departing Country's exchange control regulations.

Most New York law-governed loan documents for cross-border transactions include "judgment currency" provisions purporting to indemnify lenders for losses resulting from the purchase of the original loan currency with the sum the lenders receive in the judgment currency. The validity of such clauses has never been affirmed by a court in New York, and legal opinions typically include an exception as to their enforceability.[10] Lenders should continue to include these indemnities in their cross-border loan arrangements for whatever they are worth; yet, even if they are enforceable under New York law, one questions whether courts in the Departing Country would give effect to them to compel payment in euros of a New York euro-denominated judgment.

> New York courts have set a high bar for finding impossibility or frustration of a contract.

Performance Excuses

Impossibility and Frustration. The capital and/or exchange control policies that a Departing Country will likely impose could, in practice, restrict or delay the outward movement of cash from the Departing Country borrower or prohibit the borrower from making payments in euros. This could embolden borrowers to assert in New York courts that the doctrines of impossibility or frustration of purpose excuse them from performing their obligations to pay in euros. New York courts, however, have set a high bar for finding impossibility or frustration of a contract. Assuming euros are still available for purchase outside the Departing Country, it is unlikely that borrowers could interpose these doctrines successfully.[11] Then again, if the Departing Country's regulations prohibit the borrower from sending the redenominated currency out of the Departing Country to purchase euros outside the Departing Country, this could theoretically give rise to a claim that the borrower should be excused from making payment in euros. In that case, lenders will be in the same position as they would be enforcing a euro-denominated judgment in the Departing Country and, thus, may be able to collect the debt only in the new currency.

Illegality. A Departing Country's currency redenomination and capital and/or exchange control policies could also make it illegal for lenders to fund loans in euros to a borrower in the Departing Country or for such a borrower to borrow in euros. Most syndicated multi-currency loan agreements include two provisions dealing with such an event: a Eurocurrency indemnity, which requires the borrower either to prepay the euro-denominated loan or to convert it into U.S. dollars; and a Eurocurrency funding provision, which permits lenders to suspend their commitment to fund loans in euros.

Events of Default

Customary syndicated loan agreements governed by New York law do not include a currency redenomination or withdrawal of a Eurozone member from the euro as a specific event of default. Nevertheless, depending on the circumstances, other events of default might be implicated.

Cross-Border Defaults. Many loans to foreign borrowers include defaults for certain political and other risks that are often hedged by insurance. These include, for example, war, revolution, expropriation, nationalization and the like; a debt moratorium, currency inconvertibility or other similar governmental action; a treaty materially impairing a loan provision; the government becoming unable to pay its debts when due (including especially if the loan is to a foreign sovereign); and the borrower is no longer authorized or cannot make payments in the specified currency. If the credit agreement contains such an event of default, whether it might be triggered will depend on its wording and the redenomination legislation's substance.

Failure to Pay. Where the loan agreement requires payment in euros but the borrower is unwilling or unable to do so and tenders payment instead in the new national currency, this could constitute, under New York law, an event of default for nonpayment, unless payment in the new currency results in the lenders' actual receipt of the full amount that they were owed in euros. If the lenders seek enforcement in the Departing Country, however, the courts there may well determine that the payment by the borrower in the new currency constituted legal tender by virtue of the redenomination legislation.

Material Adverse Change and Insolvency. If a country leaves the Eurozone, it is probably doing so because of its own financial distress. Likewise, borrowers in (or with subsidiaries or substantial operations and assets in) the Departing Country may be financially distressed due to negative consequences triggered by a redenomination, e.g., limited or no availability of credit or devaluation of the new domestic currency against the euro). Moreover, if borrowers depend heavily on euro-denominated revenues from their operations in a Departing Country, it may be difficult for them to service their debts if their revenues are redenominated into the new currency. Borrowers may also have limited or no ability to hedge against such currency risks due to the unavailability or prohibitive cost of currency swaps following the redenomination.

Depending on the circumstances and the specific provisions in the loan agreement, such events could trigger a material adverse change (MAC) provision in the loan agreement, resulting in either a funding block or an event of default, particularly if the MAC clause is defined by reference to the business, assets, financial condition, or results of operations of the borrower or the borrower's ability to perform its obligations under the loan agreement. Moreover, the bad economic circumstances prevailing in the Departing Country may indeed have rendered the borrower insolvent, which could trigger a bankruptcy/insolvency event of default.

The policies adopted by the Departing Country may also affect other loan agreement provisions, such as the borrower's reporting duties if a material adverse change occurs. Additionally, borrower representations regarding non-conflict with law or regulations and governmental approvals could be breached if the Departing Country enacts laws prohibiting payment in euros of the euro-denominated loan obligations.

Protective Measures

Lenders need not wait until a Eurozone departure occurs before taking action. There are several steps they can implement to protect themselves in advance, including one or more of the following:

- If the loan documents are governed by New York law, include an express submission by the borrower (and any guarantor) to jurisdiction exclusively (or at least non-exclusively) in New York.
- Ensure that the currency definitions and payment provisions specify the euro as the sole currency for repayment of the euro-denominated loan obligations and that such provisions do not refer generally to the lawful currency from time to time of the Departing Country.
- Designate an account in the United States (or at least in a jurisdiction outside the potential Departing Country) as the place for payment of the euro-denominated loan obligations.
- Specify that a currency redenomination or exit by the relevant country from the Eurozone constitutes an event of default or at least permits the lenders to cease funding loans in euros.
- Ensure that the loan agreement includes a Eurocurrency indemnity that adequately protects the lenders if a Eurozone withdrawal occurs.
- Incorporate a "substitution of currency" feature. This novel provision has appeared in several recent U.S. multi-currency credit agreements. Under it, if a redenomination occurs, the loan agreement will be amended to the extent determined by the lenders to reflect the change in currency and to keep them at the status quo so far as possible. The value of this provision, at least without more specifics, is debatable since the parties have agreed only to amend the document in the future rather than on the actual amendments; the clause may thus be unenforceable as a mere agreement to agree.
- Supplement the judgment currency indemnity. A few of the new substitution of currency provisions attempt to enhance the judgment currency indemnity if a judgment is denominated in a currency other than the original loan currency. They require the borrower and the domestic entities party to the loan agreement to indemnify the lenders for any deficiency resulting from variations in exchange rates from the date the original loan currency is converted into the judgment currency and the date of actual payment. Whether this supplemental indemnity would render any different result from or be less vulnerable than the customary judgment currency clause is an open question.
- Restructure the euro facility's economics. Lenders should ensure that their loan pricing and structure reflect the risk of a Eurozone departure sufficiently. It may be appropriate to require extra credit support in the form of a guarantee by a parent (assuming the parent itself is not located in the Departing Country) of the loan obligations (or at least the obligations under the euro-tranche facility or just the Eurocurrency and judgment currency indemnities) or, if the borrower has assets in other jurisdictions, additional collateral to secure the euro-denominated obligations. Lenders might also lower the advance rates for borrowing base loans, require more frequent cleanups of revolving facilities and consider other steps they deem prudent in light of the additional credit risk they are assuming for lending euros to a borrower in a potential Departing Country.

Conclusion

Whether a country will withdraw from the Eurozone and what procedures it would adopt in that case are difficult to predict. Nevertheless, it behooves lenders who have euro-denominated credit facilities to consider the implications of such an event on their existing and new credit facilities before it occurs and to take appropriate prophylactic measures to minimize their exposure.

1. Eurozone countries include Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain. Also, Andorra, Kosovo, Montenegro, Monaco, San Marino and Vatican City use the euro as their currency although they are not EU members.

2. A country's exit from the EU and the EMU might occur in several ways, ranging from an EU-approved withdrawal to a unilateral withdrawal or expulsion. The Consolidated Version of the Treaty on European Union provides that countries can withdraw by giving notice to the European Council of their intent to withdraw, followed by the negotiation of a withdrawal agreement between the withdrawing state and the EU. The treaty is silent, however, regarding withdrawal from the single European currency. See Consolidated Version of the Treaty on European Union, art. 50, Dec. 13, 2007, 2008 O.J. C115; P. Athanassiou, "Withdrawal and Expulsion From the EU and EMU—Some Reflections," Legal Working Papers Series No. 10 (European Central Bank, Dec. 2009), at 23.

3. The complete elimination of the euro as the Eurozone's single currency is highly improbable and would doubtless prove catastrophic, so a discussion of its consequences is beyond the scope of this column.

4. N.Y. Gen. Oblig. Law §5-1401 permits parties to an agreement involving a commercial transaction of $250,000 or more to specify New York law as the law governing their agreement, whether or not the agreement "bears a reasonable relation to" New York. Under §5-1402, New York courts are required to take jurisdiction of disputes under agreements involving transactions covering $1 million or more where the parties have chosen New York law to govern their agreement pursuant to §5-1401 and agreed to submit to the jurisdiction of the New York courts.

5. N.Y. Gen. Oblig. Law §§5-1601, et seq.

6. See *Die Deutsche Bank Filiale Nurnberg v. Humphrey*, 272 U.S. 517, 519 (1926); *Transamerica General v. Zunino*, 82 N.Y.S.2d 595, 604 (Sup. Ct. NY Cty, 1948) (citing *Zimmerman v. Sutherland*, 274 U.S. 253, 255 (1927)).

7. The Act of State Doctrine assumes the validity of public acts of a sovereign state in its own territory. See D.T. Kramer, Annotation, "Modern Status of the Act of State Doctrine," 12 A.L.R. Fed. 707 (1972). See also *Underhill v. Hernandez*, 168 U.S. 250 (1897); *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1964).

8. See *Braka v. Bancomer*, 762 F.2d 222 (2d Cir. 1985).

9. N.Y. Jud. Law §27(b). Federal courts sitting in New York in diversity cases must also apply the New York rule. See 28 West's New York Practice Series New York Contract Law §22:27 (2006).

10. See R. Wright, et al., The LSTA's Complete Credit Agreement Guide §12.8.5 at 560 (2009). Enforceability might be questioned on the ground that the currency indemnity claim merges into and cannot survive the judgment. See A.S. Holderness, Jr., et al., Legal Opinion Letters Formbook §7.02 at 139 n.73 (3d ed. 2011).

11. New York courts follow the strict common law rule of impossibility, which is limited to the destruction of the means of performance by an act of God, an exercise of government authority, or by law. The party asserting impossibility must prove that the event was unforeseeable, it destroyed the subject matter or the means of performing the contract and thus rendered performance impossible, and the risk of its occurrence was not assumed. See *407 East 61st Garage v. Savoy Fifth Ave.*, 23 N.Y.2d 275, 281 (1968). See, e.g., *Encyclopaedia Universalis v. Encyclopaedia Britannica*, No. 03 CIV. 4363. 2003 U.S. Dist. LEXIS 21850, at **23-24 (S.D.N.Y. Dec. 4, 2003); *Kel Kim v. Central Mkts.*, 70 N.Y.2d 900 (1987). A party asserting frustration of purpose under New York law must prove that the frustration is substantial; the frustrated purpose is so fundamental to the contract that, without it, the transaction does not make sense; the frustrating event was unforeseeable; and no provision could have been made for that event's occurrence. See *Crown It Services v. Koval-Olsen*, 11 A.D.3d 263, 265 (1st Dept. 2004); and *Warner v. Kaplan*, 71 A.D.3d 1, 6 (1st Dept. 2009).