Briefing note

May 2012

Eurozone – developments in loan documentation

As Eurozone concerns continue so does the market's focus on the role that loan documentation has to play in addressing potential redenomination risk. In this update to our earlier briefing The Eurozone Crisis and Loan Agreements, we highlight the documentary developments arising since that earlier briefing.

Importance of fundamentals

Our briefing *The Eurozone Crisis and Loan Agreements* explained the importance of: (i) jurisdiction; (ii) governing law; (iii) currency of payment provisions; and (iv) place of payment in determining the impact of a unilateral departure from the Euro by an EU member state and a redenomination of a borrower's obligations under that state's domestic law. These fundamentals remain a lender's primary documentary protections against a unilateral redenomination by an EU member state and continue to be subject to an enhanced level of focus.

Credit support from unaffected entities

One possible response to redenomination risk is to lend to a borrower which is located (and which has assets located) either outside of the EU member state perceived to be at risk of redenomination or outside of the Eurozone or EU as a whole. Where this is not a viable option, another alternative is to seek credit support for the borrower from such an entity.

The classic form of third party credit support in the loan markets is a guarantee, most often from another member of the borrower's group, and often contained in the relevant loan agreement itself. A guarantee is a secondary obligation which means that the guarantor's obligations mirror those of the borrower. As a result, if the borrower's payment obligations are redenominated, the guarantor's are likely to be too. Lenders relying on the credit support of a guarantor to provide protection against redenomination of a borrower's obligations should, therefore, ensure that the conventional form of guarantee is supplemented with a specific obligation from the guarantor covering the lenders' loss arising from the redenomination of a borrower's payment obligations and acting as an independent undertaking from the guarantor which would not automatically be affected by the redenomination of a borrower's obligations in the way that a conventional guarantee would be.

It is important to note though, that such a device is not a silver bullet for redenomination risk: it could always be at risk of being impacted itself by redenomination legislation (particularly any implemented on a pan-European basis) and is obviously dependent on finding a guarantor

Key issues

- The on-going problems in the Eurozone mean that documentation is evolving in response to potential redenomination risk.
- The fundamentals of jurisdiction, governing law and place and currency of payment remain key.
- If relying on a guarantee from an entity outside the Eurozone to cover redenomination risk that guarantee should be supplemented with a specific obligation.
- It might be advisable to make amendments to a loan's governing law and jurisdiction subject to all lender consent.
- A mechanic allowing lenders to convert a borrower's obligations from Euro to another currency has obvious attractions for lenders but the likely difficulty of agreeing it with a borrower might limit its use in a transaction.

commercially willing to accept the extra liabilities. However, it should ensure that, on the face of an agreement at least, the guarantor provides coverage against redenomination risk.

In the absence of guarantor coverage from outside the relevant EU member state / Eurozone / EU is there value in obtaining similar protection from the borrower itself against loss arising from redenomination of payment obligations? Whilst additional protections are very rarely a bad thing for lenders the comfort in the context of a redenomination is likely to be illusory. This is because, as a practical matter, it is highly likely that the effect of any such coverage from the borrower itself would be nullified by legislation redenominating the borrower's payment obligations.

Governing law and jurisdiction in focus

As also explained in our briefing *The Eurozone Crisis and Loan Agreements*, a choice of the law of, and jurisdiction of the courts of, a state at no risk of leaving the Euro as the governing law and jurisdiction of a loan agreement may help to ensure that a unilateral redenomination under the laws of an EU member state departing from European Monetary Union should not affect the borrower's obligations under that loan agreement. In light of this there are a couple of noteworthy documentary aspects starting to emerge:

Amendment to choice of governing law and jurisdiction: Lenders should be aware that amendments to the choice of governing law or jurisdiction of a loan agreement have traditionally not been included as one of the few amendments that require all lender consent. Whilst the likelihood of the requisite majority agreeing to a borrower's request to change the governing law or jurisdiction of a loan might seem slim, especially if the backdrop to that request is redenomination concerns, it would seem a sensible precaution to require all lender consent for a change to the governing law or jurisdiction of a loan agreement in future transactions.

Dual-law structures: For lenders there is often an inherent tension between (i) increased protection from redenomination risk, which might, in some instances, militate towards a choice of English law as the governing law and (ii) the potential for a loan to be eligible as collateral for the ECB's liquidity operations, militating towards a choice of the law of a Eurozone state as the governing law. A number of recent transactions have been documented using a dual-law structure, aimed at enabling borrowers to maximise available market liquidity by allowing lenders signing up to the same deal to opt either for increased protection against potential redenomination risk or ECB eligibility.

Contractual redenomination framework

Modern financial contracts have many pages stipulating desired outcomes on specified events and providing for a contractual fallback position on the full or partial break-up of the Eurozone has attractions. The broad approach would be to give lenders the option to redenominate the borrower's Euro denominated obligations into (for example) US Dollars on a specified trigger event (such as departure from the Euro by one or more EU member states or even a broader break-up of the currency union).

The potential advantages for lenders of providing for increased certainty and a considered outcome in preference to relying on whatever any legislation may, or may not, provide are clear although the borrower may not see it that way and so pushback may well arise during negotiations. To be effective, careful consideration would be required of: (i) the trigger event allowing the contractual redenomination; (ii) the alternative currency; (iii) the fixing of an appropriate exchange rate; and (iv) the effect on the lenders' Euro denominated lending obligations.

It is important to note though that such a mechanic is not without obstacles. It could well be overridden by the relevant redenomination legislation and if construed as an "exchange contract" may be at risk of being affected by any exchange controls imposed as part of that legislation. Commercially a borrower may also resist giving its lenders the power to convert its repayment obligations into another currency, especially where that could exacerbate mismatches between its assets and liabilities.

Looking forward

As events continue to unfold we may see increasing focus on these, and other, provisions. Whilst current attention seems centred on mitigating potential redenomination risk, time will tell whether the on-going adverse conditions in the Eurozone will impact on loan documentation in other ways, such as tighter lending terms generally or sovereign risk based events of default.

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