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Troubleshooting OTC Euro Transactions

Law360, New York (May 04, 2012, 11:17 AM ET) -- Recent events in Europe have raised interesting hypothetical questions concerning over-the-counter derivatives that exchange payments in euros ("OTC euro transactions"): What would happen if the euro collapsed, or if one or more countries exited the European economic and monetary union (the "Eurozone")?

The threat of a Eurozone breakup reached an apex as tensions mounted over Greece's precarious economic status. Although an agreement was reached in late February between the Greek government and Eurozone finance ministers[1], and fears have greatly eased, there is continued concern over financial instability in Italy, Portugal and Spain.[2]

This article examines whether the collapse and subsequent disappearance of the euro would qualify as an "impossibility" or a "force majeure" event under OTC euro transactions governed by ISDA Master Agreements, as well as exploring other potential legal questions that could arise.

ISDA Master Agreements

Globally, over 90 percent of over-the-counter derivatives transactions rely on Master Agreements promulgated by the International Swaps and Derivatives Association Inc. (ISDA) — in particular, the 1992 ISDA Master Agreement or the 2002 ISDA Master Agreement.[3] Under the ISDA Master Agreements, a party generally has the right to terminate transactions upon the occurrence of an "Event of Default" or a "Termination Event" with respect to its counterparty.

As expected, the listed Events of Default and Termination Events do not specifically include a Eurozone breakup or the cessation of the euro. The User's Guide to the 1992 ISDA Master Agreements, however, includes a definition of "impossibility" as an additional termination event that parties can choose to include in their agreement. An impossibility event is generally defined as "the occurrence of a natural or man-made disaster, armed conflict, act of terrorism, riot, labor disruption or any other circumstance beyond [the party's] control."[4] The 2002 ISDA Master Agreement includes "force majeure or act of state" as a basis for an Event of Default.[5]

Under these provisions, there is a question as to whether a partial Eurozone breakup in which one or more countries exit the Eurozone would constitute an impossibility event or a force majeure event with respect to OTC euro transactions. For instance, the mere exit of one or more countries, with the concomitant reintroduction of the previous local currency in those countries, would not prevent any party to a transaction from making or receiving payments in euro. If the entire Eurozone collapses, however, leading to the cessation of the euro, what happens becomes less clear. ISDA has not indicated what it would do regarding the collapse and possible disappearance of the euro.[6]

In the absence of an industry protocol or other legally managed process, a complete collapse and cessation of the euro would give rise to arguments that an impossibility or force majeure event has occurred, thereby giving a party the right to designate an early termination date with respect to the outstanding transactions.

For instance, a non-affected party invoking these provisions would have reasonable grounds to argue that upon a total collapse, the performance of a euro-denominated payment obligation is impossible, and that any failure to make such payment should be treated as a force majeure event.[7] The affected party, however, could argue that the impossibility or force majeure event provisions are not applicable, even in the context of a complete Eurozone collapse.

The purpose of these provisions, one would argue, is to account for events such as natural or man-made disasters, labor disruptions, acts of terrorism, or acts of state (such as foreign invasion, e.g., the 1990 Iraqi invasion of Kuwait).[8] The mere replacement of one currency with another, such as reversion to a pre-euro local currency, does not seem to rise to the same level as the specifically contemplated impossibility or force majeure events.[9]

Finally, a party opposed to the position that a Eurozone collapse triggers an impossibility or force majeure event under the ISDA Master Agreements might point to language stating that such an event will be triggered only if the party affected by the perceived force majeure or impossibility is unable, "after using all reasonable efforts," to overcome the impossibility, and such party does not otherwise fail to make the payment owed (thus avoiding an event of default under the ISDA Master Agreement for failure to pay).[10]

One might argue that "reasonable efforts" would include tendering payment in an alternate currency. The ISDA Master Agreements, however, do not specifically address the situation of the contractual currency of a transaction disappearing from use such that no reasonable conversion is possible. Thus, whether payment in an alternate currency effectively discharges the payor's obligation under the ISDA Master Agreements remains an open question.[11]

New York Law

If ISDA itself or its Master Agreements do not provide any definitive answer, a relevant historical point of reference might be New York's enactment of the Continuity of Contract statute in 1997.[12] The Continuity of Contract statute provides that New York law-governed contracts affected by the adoption of the euro and retirement of local currencies would not give either party a right to unilaterally alter or terminate those contracts.

It should be noted, however, that this statute, like ISDA's EMU Protocol, was addressing the specific event of the euro's replacement of local currencies, and not the converse situation. Indeed, one might argue that the existence of the Continuity of Contract statute sheds little light on the impact of a potential Eurozone collapse, as the statute states that "[i]n circumstances of currency alteration, other than the introduction of the euro, the provisions of this title shall not be interpreted as creating any negative inference or negative presumption regarding the validity or enforceability of contracts, securities or instruments denominated in whole or in part in a currency affected by such alteration."[13]

For ISDA Master Agreements (as well as other contracts) governed by New York law, the parties may also turn to the Continuity of Contract statute's language of "commercially reasonable substitute" and "substantive equivalence" to determine whether payment in an alternate currency might be acceptable.[14] Such language is reflective of New York's doctrine of substantial performance, which holds that a party's performance — if substantially equivalent, beneficial and available to the counterparty — keeps the contract valid and enforceable.[15]

Independently of any force majeure or impossibility clause in the contract, parties seeking to avoid their obligations under New York law-governed contracts may also turn to the common law doctrines of impossibility and frustration of purpose.[16] The impossibility doctrine relieves a party of its obligation to perform if such performance has become impossible or totally impracticable as the result of an unforeseen event — the risk of which has not been allocated between the parties by the contract or by custom.[17]

In the event that one or more countries exit the euro, a party's obligation to tender payment in euros will not be objectively impossible, even if it might create financial hardship, as the euro would still be available for use. In the event of a complete collapse of the Eurozone, however, the euro would disappear as a valid currency, thereby rendering it objectively impossible for any party to tender payment in euros. At this juncture, a reviewing court might be forced to turn to the concept of substantial performance and determine whether an alternate currency is acceptable.

Another ground for avoiding contractual obligations under New York law is the doctrine of frustration of purpose, which is triggered if an unanticipated contingency has occurred, the risk of which has not been allocated by agreement or otherwise, and performance by one party would no longer give the other party the benefit for which he originally bargained.[18] As with the impossibility doctrine, an opposing party could argue that a Eurozone collapse was neither unanticipated, nor was the risk of such unallocated. Moreover, it may be difficult for a party claiming frustration of purpose to prevail on the third prong of the test, which requires that the "wholly unforeseeable event renders the contract valueless to one party."[19]

Redenomination

If neither the impossibility nor frustration of purpose doctrines vitiate the contract, and if no fallback currency is expressed in the terms of the agreement, a court then would have to decide whether and how to redenominate the contractual obligations. As noted above, if local law governs a contract and the question is to be decided by a local court, then local legislation may mandate that the court redenominate into the new local currency.[20]

In the absence of specific legislation, however, the court may adhere to the lex monetae principle, pursuant to which redenomination to the local currency of the exiting country is appropriate if a sufficient nexus exists to that exiting country.[21] In the scenario of a complete Eurozone collapse leading to the disappearance of the euro as a currency, existing contractual obligations may all be redenominated into the various new local currencies on the basis of the lex monetae principle. If redenomination to a single currency under lex monetae is not available because there is no sufficiently strong nexus to a single country, then impossibility, impracticability, or frustration of contract may apply.

Conclusion

Parties to OTC euro transactions, or other contracts that could have embedded terms that might prove impossible to comply with, should be aware of the potential rights and obligations in their contracts and under the applicable governing law. As explained in the example above, parties to OTC euro transactions should pay closer attention to the applicability of force majeure, impossibility, or frustration of purpose, and other fallback options available either under the contract or applicable governing law. Parties can then consider including provisions that are tailored to minimize uncertainty, such as, in the case of OTC euro transactions, provisions that specify an alternate currency or basket of currencies in the event the euro becomes altered or is no longer available.

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[1] See Stephen Castle, Europe Agrees on New Bailout To Help Greece Avoid Default, N.Y. TIMES, Feb. 20, 2012 at A1.

[2] See, e.g., Peter Spiegel & Miles Johnson, Europe Warned Crisis Not Over Yet, FIN. TIMES, Mar. 30, 2012, available at http://www.ft.com/intl/cms/s/0/e07e1b8e-7a8a-11e1-8ae6-00144feab49a.html; Portugal's Situation Remains Tenuous, IMF Says, ISDA DAILYLEAD, Apr. 6, 2012, available at http://www.smartbrief.com/news/isda/storyDetails.jsp?issueid=93A1AEF7-F61F-4EB0-9E62-201015F804D6©id=1F7A50E0-D694-4C81-9585-5AD54A0880E8; Ana Nicolaci da Costa, Spanish Bank CDS Jumps as Contagion Risks Spread, REUTERS, Apr. 5, 2012, available at http://www.reuters.com/article/2012/04/05/markets-money-idUSL6E8F5A8M20120405.

[3] See Barry Donnelly & Jonathan Pratt, ISDA Master Agreement: 'Probably the Most Important Standard Market Agreement Used in the Financial World', THE IN-HOUSE LAWYER, Apr. 8, 2011, available at http://www.inhouselawyer.co.uk/index.php/litigation-a-dispute-resolution/9312-isda-master-agreement-probably-the-most-important-standard-market-agreement-used-in-the-financial-world. This article will focus on OTC euro transactions governed by New York law.

[4] See ISDA, USER'S GUIDE TO THE 1992 ISDA MASTER AGREEMENTS 64-66 (1993). Depending on the negotiations of the ISDA Master Agreement, it can provide for additional termination events due to impossibility or force majeure (or other specifically tailored events).

[5] ISDA, 2002 Master Agreement § 5(b)(ii) (2002). The suggested wording of the "impossibility" clause from the User's Guide to the ISDA 1992 Agreements references "the occurrence of a natural or man-made disaster, armed conflict, act of terrorism, riot, labor disruption or any other circumstance beyond [the party's] control." USER'S GUIDE TO THE 1992 ISDA MASTER AGREEMENTS 64.

[6] ISDA addressed the emergence of the euro by issuing the ISDA EMU Protocol in 1998. See ISDA, EMU Protocol, Annex I ISDA EMU Continuity Provision § (a) (1998). Parties to ISDA Master Agreements were afforded the opportunity to clarify, by adopting the EMU Protocol, that the change from local currencies to the euro would not result in an Event of Default or Termination Event. It is worth noting that the EMU Protocol was — and any similar protocol that ISDA could promulgate in the present situation would be — an optional tool that parties to an ISDA Master Agreement could use. They are not mandatory and do not have the force of law, but can become new contract provisions if the parties so expressly adopt.

[7] Such an argument could also reference the User's Guide to the 1992 ISDA Master Agreements, which included Iraq's 1990 invasion of Kuwait and the replacement of the Kuwaiti dinar with the Iraqi dinar as grounds for an "impossibility" Termination Event. See USER'S GUIDE TO THE 1992 ISDA MASTER AGREEMENTS 64.

[8] New York courts have noted: "Force majeure, literally 'a superior force' in French, is most frequently applied to Acts of God or events in nature, which are neither anticipated nor controllable, but it may well apply to 'governmental prohibitions.'" Trump on Ocean LLC v. Ash, No. 005274/2009, 2009 WL 2619233, at *3 (N.Y. Sup. Ct. Aug. 25, 2009). In New York, "[i]nterpretation of force majeure clauses is to be narrowly construed and only if the force majeure clause specifically includes the event that actually prevents a party's performance will that party be excused." Reade v. Stoneybrook Realty LLC, 882 N.Y.S.2d 8, 9 (N.Y. App. Div. 2009).

[9] See, e.g., Urban Archaeology Ltd. v. 207 E. 57th Street LLC, 891 N.Y.S.2d 63 (N.Y. App. Div. 2009) (finding that financial hardship did not excuse performance under force majeure clause or doctrine of impossibility).

[10] See 2002 ISDA Master Agreement § 5(c)(ii); ISDA, USER'S GUIDE TO THE 2002 ISDA MASTER AGREEMENT 17 (2003); USER'S GUIDE TO THE 1992 ISDA MASTER AGREEMENTS 65.

[11] See ISDA, 1992 Master Agreement § 8(a) (1992) (providing that a payment obligation will not be discharged to the extent it is made in a currency other than the currency specified in the transaction unless such other currency can be converted into the contractually agreed-upon currency).

[12] N.Y. GEN. OBLIG. LAW § 5-1601 et seq. New York enacted the Continuity of Contract statute to address the rights and obligations of parties to any New York contracts involving a currency that was being replaced by the euro.

[13] N.Y. GEN. OBLIG. LAW § 5-1604(2) (emphasis added).

[14] N.Y. GEN. OBLIG. LAW § 5-1602(1)(b).

[15] See Jacob & Youngs v. Kent, 129 N.E. 889, 890-92 (1921).

[16] See Metpath Inc. v. Birmingham Fire Ins. Co. of Pa., 449 N.Y.S.2d 986, 988-89 (N.Y. App. Div. 1982); Moyer v. City of Little Falls, 510 N.Y.S.2d 813 (N.Y. Sup. Ct. 1986).

[17] United States v. Gen. Douglas MacArthur Senior Vill., Inc., 508 F.2d 377, 381 (2d Cir. 1974).

[18] N.Y. State Elec. & Gas Corp. v. Saranac Power Partners L.P., 117 F. Supp. 2d 211, 253 n.78 (N.D.N.Y. 2000).

[19] MacArthur, 508 F.2d at 381 (emphasis added).

[20] For example, if a New York court is the forum to decide the question and the contract specifies that New York law should govern, then the court would be bound by any statute the New York legislature might choose to enact to address the situation.

[21} Lex monetae is a conflict of laws issue that no court in the United States has yet had occasion to address. But a U.S. court may apply the rule of lex monetae as an application of the act of state doctrine. MICHAEL GRUSON, COMMERCIAL CONTRACTS: STRATEGIES FOR DRAFTING AND NEGOTIATING § 6.08[C] (Morton Moskin, ed., 2012). In contrast, it should be noted that in an English court, the question of redenomination may be complicated by whether the exit from the Eurozone was legal and consensual, or illegal and unilateral. If the exit was legal, then the court may apply the lex monetae principle. If the exit was unlawful (such as in violation of the Maastricht Treaty, the Lisbon Treaty, or other international law to which the UK is a signatory), then such unilateral withdrawal would be contrary to UK public policy. In this latter event, English courts may give no deference to the lex monetae of the exiting country, and it is possible that no redenomination would be allowed. The court may instead look to specific UK legislation or an EU directive. As the United States is not a signatory to these treaties, a U.S. court would not share these public policy concerns.

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