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Euro Contingency Planning: Why it is necessary now, what it should cover and how we can help

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If you have not yet carried out Euro Contingency Planning, we recommend that you do so now.

Why now? Despite the market perceiving the results of last Sunday's Greek elections as a positive development, uncertainty regarding the future of the euro, the eurozone and the EU itself remain in abundance. The various scenarios for the future of the euro, ranging from a single member state leaving the eurozone to the full deconstruction of the euro, make it imperative for companies to take action now. The companies that will weather the coming storm the best will inevitably be those who have proactively considered the various scenarios and implemented plans to mitigate the risks associated with each scenario.

How can we help? Reed Smith established a Eurozone Response Group in Q3 of 2011, offering a wealth of experience to clients seeking to understand the current situation in Europe and to work out defensive and other strategies in the uncertain environment in which we currently find ourselves. We can help by working with you to ensure that your exposure to risks such as a eurozone member exit, a deconstruction of the euro, a sovereign default or a banking crisis is assessed and mitigated to the extent possible.

What should your Euro Contingency Plan address? Set out below are the key risks which your Euro Contingency Plan should address.

Redenomination risk

Where payments, collateral, or security are denominated in euros under a contract, euro payment obligations may be redenominated into the new (and most probably heavily devalued) currency. This redenomination risk is most acute where a contract is governed by the laws of the member state leaving the euro (an "Exiting Member State"), the contract is performed in that Exiting Member State, and the euro is defined by reference to the currency of the member state. Redenomination risk should be considered when entering into any new contracts with companies located in eurozone countries, especially the southern European countries experiencing the most difficulties with sovereign debt issues.

Enforcement risk

If your contracts are governed by the laws of an Exiting Member State and/or security or collateral is in an Exiting Member State, even if you secure a judgment from a court that is entitled to require payment in euros under the applicable local law, a local court may decline to enforce the judgment of a foreign court on public policy grounds. We recommend England as a governing law and jurisdiction of choice as the courts generally seek to enforce contracts on the terms agreed between the parties and consistent with their intentions.

Contract termination risk

The departure from the euro of an Exiting Member State may trigger contractual termination provisions (e.g., a material adverse change provision). Where a contract is subject to English law, an exit scenario would also open the door to a party arguing that the exit amounts to “force majeure” or “frustration of contract” rendering the contract unenforceable under English law.

Cross-border trade risk

If an Exiting Member State is required to exit the EU in order to exit the euro, the free movement of capital and workers guaranteed under the existing EU legal framework would no longer be applicable. Further, trade tariffs could be placed on exports and imports to the Exiting Member State.

Credit risk

In respect of banks, significant write-offs of sovereign debt will reduce profitability of European banks and will have a negative impact on credit growth as banks rebuild their balance sheets, potentially creating both payment and credit risk.

Contagion risk

The exit from the euro of a single Exiting Member State could trigger bank runs in member states most affected by the sovereign debt crisis (e.g., Greece, Spain, Ireland, Italy and Portugal). A run on bank deposits would require additional emergency liquidity injections by the ECB. Concerns about this in the market will make it difficult to plan ahead and will likely lead to a significant reduction in cross-border lending and lower levels of transactional activity.

Liquidity risk

Liquidity risks could occur due to lack of confidence in banks, the euro, the eurozone economies and the potential need for an unspecified amount of additional state funding and government intervention.

Strategic risk for banks receiving government support

Any bank receiving government support is likely to lose significant control of its strategic direction and may no longer be able to make its own decisions. This could lead to the affected banks being pressured into following government proposals on euro issues.

Sovereign debt exposure risk and related regulatory capital risk linked to sovereign debt holdings by banks of heavily indebted eurozone member states

Have sufficient haircuts been taken to accurately reflect exposure to sovereign indebtedness in weaker eurozone member states, do you have sufficient liquidity to cover shortfalls and can exposures be reduced further?

Exchange control and capital control risk

This is the risk that payments and capital being made to or from an Exiting Member State will be restricted under the laws of the Exiting Member State related to the re-establishment of its national currency.

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Uncertainty risk

Will one or more member states exit the euro and, if so, will other member states follow? Is it possible for the euro or even the EU itself to break up? The uncertainty itself makes it difficult to plan ahead.

Payment risk

The risk arises when payments are denominated in euro and euro is defined by reference to an Exiting Member State's currency or where a counterparty is an Exiting Member State and simply cannot afford to pay.

Collateral/security risk

Where the collateral or security is located in an Exiting Member State, the risk that payment for, and monies payable from, the security would be redenominated into the new national currency.

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