Winter 2012

Finance Digest

The Euro in Flux: Contingency Planning for Loan Agreements

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Uncertainties persist regarding the future of the European single currency (the *Euro*), and in response loan market participants are beginning to consider the possible impact of the exit of one or more participating member states (a *Participating State*) from the Euro (an *Exit* and such exiting member or members, each an *Exiting State*) or, the more extreme scenario, the end of the Euro altogether (a *Break-Up*). In most cases, existing US loan agreements that include Euro facilities (or borrowers organized in a Participating State) do not specifically contemplate any Exit or Break-Up scenario. As a result, the precise nature of any political settlement, as well as any direct negotiations between contractual parties thereafter, will be of primary significance for resolving documentary and practical issues. It is critical, however, for borrowers and lenders to engage in early stage diligence regarding the potential effects on their loan documentation for risk assessment purposes as well as to provide a context for any future negotiations.

This article highlights practical and legal issues likely to arise under New York law governed loan agreements that would be impacted by an Exit or Break-Up and identifies key contingency planning considerations for an Exit or Break-Up. Although this article focuses on New York law governed loan agreements with Euro-denominated facilities and payment obligations, some of the considerations outlined will also be relevant for borrowers and lenders with US Dollar facilities if the borrower is organized under the laws of an Exiting State or has substantial operations or subsidiaries in an Exiting State.

Exit of One or More Euro Participants

In the event of an Exit, any Exiting State would need to enact legislation to re-establish its national currency and re-denominate deposits and payment obligations owing in Euros to such new national currency. The legislative changes that would accompany any Exit are complex and difficult to predict, in particular with respect to the scope of re-denomination rules. In addition, significant currency volatility can be anticipated and, notwithstanding current Eurozone restrictions on the establishment of capital and foreign exchange controls by any individual member, an Exiting State may establish such controls in an attempt to stabilize its currency and economy during the transition. This presents a number of legal and practical concerns for lenders and borrowers in any Euro-denominated loan transaction or where the borrower is organized or resides in an Exiting State.

The most important practical issue relates to re-denomination and payment obligations – will any payment obligation previously stated to be in Euros become re-denominated into the new national currency? For New York law governed loan agreements (with exclusive jurisdiction vested in the New York courts), the answer to this will depend largely on the provisions of the specific agreement. So long as the Euro is specifically identified as the currency of payment, the contractual currency of repayment after the Exit would remain the Euro under New York law (and any related New York law governed guarantees of such payments should remain valid). This assumes the Euro is still available following the Exit and there are no direct legal restrictions on repayment imposed by the Exiting State which might otherwise allow for borrowers to seek to reform the agreements based on common law doctrines of illegality or impossibility of performance. Where payments are required in Euros, payment in any other currency, if not accepted by the relevant lenders, could trigger a payment default. This would allow the lenders to block additional credit extensions and potentially to accelerate the applicable credit facility and pursue remedies. Such payment default could also result in cross-default or cross-acceleration of other material agreements as well as triggering the accrual of default interest. In any event, the payment provisions and definitions of "Euro" should be reviewed in any Euro-denominated loan agreement to confirm the continuity of the payment obligation in Euros.

As a practical matter, even before a borrower misses a Euro payment, payments in Euros could be complicated by illegality concerns if stringent exchange control provisions were to be introduced in the Exiting State preventing payment in Euros. Enforcement in the Exiting State may also be hindered by exchange controls or the refusal of local courts to recognize a New York judgment against the borrower (or a guarantor) based in Euros. As a result, the full extent of implementing legislation will be critical even for New York law governed loan facilities.

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Borrowers with substantial operations in an Exiting State will face additional issues (e.g. where an operating company in an Exiting State draws on a revolving facility for working capital needs or debt has been pushed down into that company for local tax reasons). If the Euro is the stronger currency and the new national currency devalues considerably (the most likely scenario with any "periphery" Exit), payment obligations owing in Euros may be difficult to service by a borrower whose business is now generating cash flow based on the new currency. Hedging such payment obligations may be equally difficult given the market uncertainties that will likely persist following an Exit. New exchange controls may also limit the ability to move cash to the relevant borrower should the ultimate borrower be in another jurisdiction.

Loan agreements often include a "material adverse change" clause which may apply as a borrowing condition or (though more rarely) as an event of default. "MAC" definitions vary and can be triggered if the financial condition or operations of the borrower are impaired and also if the ability of the borrower or guarantors to perform their obligations under the loan agreement or the ability of the lenders to exercise rights and remedies are impaired. As a result MAC clauses may be tripped due to business issues created by an Exit or as a result of restrictive implementation legislation or exchange controls themselves.

Assuming borrowers are able to continue to meet their Euro payment obligation after an Exit, under certain revolving credit facilities, such borrowers may be able to borrow or have letters of credit issued in the new currency depending on the scope of any "optional currency" provisions. Some facilities require lender consent to borrow or have letters of credit issued in a new currency, while others permit such borrowing or issuance without lender consent provided the currency is freely available to all lenders and readily convertible into Euros or US Dollars.

Break-Up of the Euro

Unlike an Exit, if there were to be a Break-Up, the Euro will obviously cease to be available altogether as a method of payment. In these circumstances, the above considerations will continue to be relevant and, in addition, it is likely that new Eurozone and country-specific legislation will prescribe a set procedure for conversion of payment currencies (as happened at the inception of the Euro). In the event of a Break-Up, loan agreements requiring payments in Euros that do not contemplate alternatives would need to be restructured. Absent agreement among the parties, New York courts would seek to evaluate the commercial intention of the parties to determine an adequate resolution. Since Euros will not be available, the common law contractual doctrines of impossibility of performance or frustration of purpose could arguably apply. Indeed, in connection with the adoption of the Euro, New York adopted a Continuity of Contract statute providing that the Euro could be used for payment and the unavailability of national currencies would not have the effect of discharging or excusing performance under any contract requiring payment in such national currencies. Although another statutory solution may be feasible especially given that so many US finance transactions are governed by New York law, conversion issues will present substantial challenges given the multiple currencies and the likely exchange rate volatility.

Absent relevant legislation, while a New York court would likely attempt to resolve the issue through "substantial performance" by use of another currency, it is hard to predict how a court would rule in determining which currency should be used to satisfy the outstanding debt. The court could consider factors such as the relevant definition (i.e. how the agreement defines "Euro", broadly or narrowly), the presence of any alternate currencies and the place of payment. In facilities where the Euro borrowing is through a sub-facility, payments and further borrowings would then revert to the base currency (oftentimes, US Dollars for New York governed loan agreements). The outcome would be less clear in a situation where borrowings were permitted in multiple currencies including Euros but there is no overarching base currency. Moreover, whether lenders are required to make additional loans and other financial accommodations (such as letters of credit) in a re-denominated currency would also be at issue. Lenders may be tempted to rely on the "judgment currency" provision of the loan agreement; however, this provision may be difficult to implement when the currency involved is that of the Exiting State and enforcement is sought through the courts of the Exiting State.

In the event of a Break-Up, loan agreements requiring payments in Euros that do not contemplate alternatives would need to be restructured.

In response to a Break-Up, Euro-based loan documentation would need to be amended to comply with generally accepted conventions and market practice in the relevant inter-bank market. New market mechanisms would need to be developed for lending in post-Euro local currencies (e.g. new reference rates to replace EURIBOR and an alternative to TARGET days for setting quotations and notice dates). Negotiation will also dictate the rate at which the amounts payable in Euros (as well as other amounts defined in Euros, such as covenant baskets and other thresholds) will be converted into other currencies. Given the likely uncertainty around the new currency's exchange rate, such impacts may be material to the parties' rights and responsibilities under the loan agreement's negotiated terms. Such developments are very difficult to plan for, but where a company operates in multiple jurisdictions with cash-flows in more than one new currency, further negotiation may be required with regard to the appropriate base currency and the possible re-tranching of the Euro debt into multiple facilities to match re-denominated cash-flows.

Key Observations

It is in the interest of the counterparties to be prepared to address Exit and Break-Up scenarios in advance even though the possibility might seem remote. Many financial institutions are taking this issue seriously and are undertaking reviews of their operations and form documentation to develop strategies that will work from their perspective. Borrowers should consider doing the same – see "Contingency Planning Checklist for Borrowers" in the box below.

If issues persist, loan documentation going forward may also begin addressing some of the issues and contingencies presented by an Exit or Break-Up. Lenders, in particular, may want to consider some of the following, depending on the circumstances:

- Consider a suspension or termination right with regard to Euro borrowings in the event of an Exit or Break-Up
- Allow for alternate currency payments in the event of illegality or impossibility (subject to cost allocation provisions)
- If the place for payment is not in New York, designate multiple places for payment, including locations outside of the Eurozone or allow for location of payment to be modified by the administrative agent
- Modify material adverse change clause to address specific Euro concerns
- Although somewhat draconian, include a specific event of default in the event of an Exit by the home country of the borrower or significant guarantors
- Strengthen indemnity clauses to allocate risk in regard to increased cost/losses

As the situation regarding the Euro progresses, we will continue to monitor market conditions and reaction to such developments and provide further information and updates.

CONTINGENCY PLANNING CHECKLIST FOR BORROWERS	
DILIGENCE	**RISK MANAGEMENT**
1. Funding obligations / Funding requirements	
Based on documentation review, identify the following:	The key risk relates to currency of payment obligations and any interruption to cashflow/funding sources:
■ Any payment obligation of the group required to be made in Euros (in particular in connection with previous drawings in Euros) and any related payment mechanics (including place of payment and payment offices).	■ Assess whether there is a definition of "Euro" in the loan agreement. ■ Form a view on which Eurozone countries are likely to be "at risk" (potentially Exiting States). ■ Under the documentation, assess the extent to which any payment obligation may be re-denominated (in whole or in part) into a new national currency of an Exiting State; and in any case, assess whether the aggregate cashflows of the business can support continued payments in Euros and/or whether a hedging mitigating solution is available/cost effective. ■ Under the documentation consider any methods to mitigate place of payment risk (such as moving payment offices).
■ Any right to drawdown amounts in the new national currency or Euro under revolving or delayed draw (capex or acquisition) facilities.	■ Assess whether any new facilities denominated in a new national currency may be required, and whether the existing documentation may provide for this right (in place of previously committed Euro-based funds). ■ If it becomes likely a new national currency is to be introduced, consider whether any revolving facility should be available in Euros (or not) prior to the introduction of that new national currency.
■ Any illegality risk that prevents funding being made in the relevant currency by a bank or payment by an obligor.	■ In particular if exchange controls are imposed, this may create a situation where funding in a currency is required to be made under the documentation (by a bank or an obligor) but that this is restricted by law.
2 Additional cost and financial model considerations	
Consider any documentation points that may give rise to a material additional cost	Consider any material additional cost in the context of the financial model
■ Review and assess basis for determining funding costs.	■ If there is a new national currency, a new basis for calculating the cost of funds will be required (as an alternative for EURIBOR) and potentially a mandatory cost formula. Consider any existing interest rate hedging arrangements in this context.
■ Consider if any additional currency hedging is required.	■ This requirement is potentially difficult to assess in advance (as well as any associated cost); however, the documentation should be checked to see whether new additional currency hedging is permitted (and permitted to be secured).
■ Consider any indemnity obligations in respect of losses for the lenders arising as a result of change of currency.	■ Again, exact amounts may be difficult to assess in advance, however, the documentation should be checked to determine if any right/claim may arise, including under specific currency indemnities and increased cost clauses.
3. Blocking or termination events	
In light of any funding and cost implications, consider whether there is any risk that the lenders have a right to terminate or block additional drawings under the loan.	Any potential argument to terminate or block additional drawings under the loan (for reasons of MAC or otherwise) is important to identify up-front prior to any negotiations with lenders. To mitigate a risk that funds may not be available, obligors should consider whether to drawdown revolving facilities in full and/or arrange local liquidity lines (to the extent permitted under the loan documentation).

4. Other consequences	
A number of thresholds and baskets are set by reference to a specified currency and these should be identified.	From a risk point of view, a change in currency will impact the following loan documentation provisions:
	▪ Determination of fixed or mandatory repayment obligations if specified as a fixed amount in Euros. ▪ Borrowing and related thresholds and sublimits. ▪ Calculation of voting thresholds (if some lenders' exposures are re-denominated). ▪ Financial covenant calculations. ▪ Calculation of baskets (especially given likely fluctuation in new currency).

If you would like more information about the contents of this issue, or about Weil's finance practices, contact the authors or your regular contact at Weil.

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Finance Digest is published by the Capital Markets, Banking & Finance, and Structured Finance and Derivatives Groups of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000. http://www.weil.com.