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EURO CONVERSION LEGISLATION: AN INADEQUATE MEANS TO PROTECT PARTIES TO DERIVATIVES CONTRACTS

*Steven H. Emery**

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I. INTRODUCTION

As the 21st century approaches, the global economy faces several important changes. Erstwhile sanguine investors in Southeast Asian countries once rushed to purchase properties in Thailand and Malaysia in order to build factories, offices, and homes.[1] However, such impressive economic growth was not sustainable, and the boom days for Southeast Asia came to an end in 1997, when many financial businesses shut their doors, and many investors pulled out of the region.[2] Although foreign direct investment in Southeast Asia has not been affected as much as portfolio investments in that area,[3] it is clear that investors are more cautious than they once were. Indeed, the terms "global financial crisis" and "global economic crisis" have entered the contemporary lexicon and continue to be a concern for economists and others alike.[4] Meanwhile, Japan is currently experiencing a recession, but could reemerge a much stronger economic player, once it addresses its formidable banking crisis. Notwithstanding these very significant changes in the world economy, another development could overshadow and also transcend them all. One commentator has predicted that the introduction of the euro will be "the most important change in the global economy well into the next century."[5] Another expert has stated that creation of the euro is "the biggest change in global finance since the dollar surpassed sterling to become the world's leading currency in the interwar period."[6] Unlike other world events that unpredictably affect financial and economic interests one year and fade away the next, the adoption and maturation of the new European currency will be enduring phenomena to be scrutinized for years to come.

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[1] *See* Vichai Suthamtarikul, The Asian Economic Crisis and Thailand's Prospects for Early Recovery 2 (Oct. 7, 1998) (a speech delivered in conjunction with the Frederick K. Cox International Law Center, Case Western Reserve University School of Law)(on file with the *Case Western Reserve Journal of International Law*).

[2] *See id.* at 2-3.

[3] *See* Jonathan Karp, *India's Bourse Turns Volatile After Skirting Turmoil for a Time*, WALL ST. J., June 23, 1998, at A17 (reporting that India never became the haven from the financial crisis that some believed it would become, and that it, too, experienced less portfolio investment).

[4] For an example of this phenomenon, see Peter G. Gosselin, *Brazil Woes Shake World Marketplace*, BOSTON GLOBE, Jan. 14, 1999, at A1.

[5] *See* Jeffrey E. Garten, *The Euro Will Turn Europe Into a Superpower*, BUS. WK., May 4, 1998, at 30, 30. It is also important to recognize that the creation of the euro has implications for European cultural identity, because the currency creates a new symbol for the region, as important as a flag or an army. *See* Isabel Hilton, *E Pluribus Euro*, NEW YORKER, Apr. 27 & May 4, 1998, at 64.

[6] C. Fred Bergsten, *America and Europe: Clash of the Titans?*, FOREIGN AFF., Mar.-Apr. 1999, at 20, 22.

First, this Note seeks to introduce the reader to the wider context within which the euro finds itself. Second, it identifies the key events that establish the euro as the new currency within the European Union. Third, it recognizes that most contracts stipulating amounts in retired currencies will probably be immune from litigation, but warns that derivatives contracts which specify former currencies do pose a potential risk. Fourth, this Note describes the various legislative responses to the threat that the introduction of the euro could possibly pose to the continuity of contracts. Fifth, it evaluates these responses in terms of their necessity and adequacy. Lastly, it encourages lawyers and legislators to carefully address this issue and sets forth several recommendations.

Fascination with the euro is justified for many reasons. As a result of monetary union, Europe will become a more united and potent economic region with almost 20% of the world's trade.[7] The euro will compete with the U.S. dollar as a world currency reserve, and challenge American dominance in the area of monetary policy.[8] However, the prospect that demand for U.S. dollars will decrease as compared to demand for other currencies may be exaggerated by scholars and commentators. If one looks at foreign exchange reserves over a long time period, a pattern of diversification seems to have developed. Thus, the threat to the dollar could be more gradual than some are predicting.[9] Nevertheless, the new currency of Europe stands poised to be an influential player in the broader world market as well.

The introduction of the euro will have other important effects. Trade and competition within Europe will increase at a quick pace, because it will be less complicated to trade products and services across national borders.[10] European companies will feel pressure to become leaner and more efficient,[11] as U.S. companies did in the late 1980s and early 1990s. Moreover, mergers

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[7] *See* Jorge Pedraza, *The Euro Cometh: Bringing Unity or Fratricide?*, COMMONWEALTH, June 5, 1998, at 9. Some see the introduction of the euro as a bald-faced attempt by some European countries to keep a reunited Germany in check. For a discussion of this, see Gwynne Dyer, *Euro: The Biggest Shift in World Financial Order*, JAKARTA POST, Dec. 30, 1998, *available in* 1998 WL 22289711 (arguing that "[t]he only reason that eleven European countries are getting a single currency next month is that Germany was reunited nine years ago last month.").

[8] *See* Pedraza, *supra* note 7, at 9; David R. Francis, *Will Euro Create New World Order?*, CHRISTIAN SCI. MONITOR, Jan. 4, 1999, at 1.

[9] *See* Paul Temperton, *The Euro, the Yen, and the Dollar, in* THE EURO 160, 162 (Paul Temperton ed., 1997). Indeed, some say that it is unlikely that the euro will supplant the dollar as the holding currency of government reserves. *See* Tonya D. Horton, *An Introduction to the Euro*, 3 N.C. BANKING INST. 435, 448 (1999) (citing Patricia Pollard, *The Role of the Euro as an International Currency*, 4 COLUM. J. EUR. L. 395, 395-96, 403 (1998)).

[10] *See* Garten, *supra* note 5, at 30.

[11] *See id.*

will occur more frequently, creating much larger European conglomerates.[12] In fact, mergers in Europe have already increased 48% in 1997, up to a total of $384 billion.[13] If monetary union in Europe indeed does effectuate the commercial developments that are predicted, the region will reap great economic benefits.

The adoption of the euro currency necessitates planning on the part of businesses around the world. Marketing, sales, finance, and legal professionals will have to implement strategies to make their own transition to the euro smooth.[14] Careful preparation in those and other areas is critical if companies wish to be ready to transact business with the new, more unified Europe.

II. A TIMELINE OF EVENTS

Despite the quixotic misconceptions some may hold, European monetary union requires a lengthy multistage process that will likely be neither facile nor expeditious. On January 1, 1999, eleven European countries adopted the euro as their official currency.[15] The complete transition to the euro will take years, but official adoption was the first major step, at which time the euro first began to coexist with the legacy currencies[16] such as the Austrian schilling and the Italian lira. Since January 1, 1999, stocks, government bonds, bank account transfers, credit card payments, and prices have been measured in euros as well as legacy currencies.[17] Also on this date, exchange rates between the euro and the

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[12] *See id.*

[13] *See* Thane Peterson, *The Euro*, BUS. WK., Apr. 27, 1998, at 90, 92. This trend is continuing into 1999. American lawyers in the mergers and acquisition area would be well advised to respond to these developments and position themselves to protect their clients interests. "The message for Americans is to think of companies in the new currency bloc as Europeans, rather than French, German, etc., and to develop partnerships and alliances with acquirers, financiers, and m & a service providers on the Continent with a pan-European view." Michael L. Sklar & Mark R. Williams, *How the Euro Deals a Stronger Hand to European Buyers*, MERGERS & ACQUISITIONS, Jan.-Feb. 1999, at 23, 24.

[14] *See* Guy D. Billoud, *Implications for International Business of European Economic and Monetary Unification*, BUS. ECON., Jan. 1998, at 38; *see also Auditors Warned to Prepare for Euro*, ACCOUNTANT, Jan. 1, 1999, at 4, *available in* 1999 WL 11511252.

[15] *See* Joseph Smallhoover & Bernardine Adkins, *Euro Transition Period Poses Choices*, NAT'L L.J., July 27, 1998, at B13. These eleven nations are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. *See id.*

[16] The term "legacy currencies" refers to the individual national currencies used by countries that will eventually use only the euro.

[17] *See* Peterson, *supra* note 13, at 92-93.

legacy currencies were finalized.[18] Before their retirement, the legacy currencies will either rise in value together, or fall in value together each day, depending on the exchange rate of the euro. Although this initial three-year stage involves only the above-mentioned electronic transactions,[19] it ushers in the momentous shift Europe is making from many currencies to one unified currency.

Three years later, on January 1, 2002, euro bank notes and coins will be put into circulation, as the legacy currencies are systematically taken out of circulation.[20] Beginning then, business can be done in both euros and the legacy currencies, and merchants will be required to display prices in euros and legacy currencies.[21] Finally, on July 1, 2002, the euro will be the only currency of legal tender for the adopting nations,[22] legacy currencies having been totally taken out of circulation.[23] The key events and dates in the transition to the euro provide a helpful context in which to examine specific international business transactions, such as swaps and derivatives.

III. THE EURO THREAT

A. *History Holds No Precedent*

Few parallels to the substitution of the euro in place of national legacy currencies in Europe exist.[24] The American colonies did not have a widely accepted currency, but rather relied on gold or silver coins, tobacco certificates, land certificates, barter, and beaver skins to accomplish trade.[25] After the American Revolution, state banks began issuing bank notes, which, although not true currency, were the de facto money of much of the 19th century.[26] By 1865, the federal government began to tax the state bank notes

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[18] *See* Alkman Granitsas & Shada Islam, *Ready or Not*, FAR E. ECON. REV., Aug. 27, 1998, at 6, 8.

[19] *See* Edmund L. Andrews, *Germans Face Losing a Loved One at Age 50: The Mark*, N.Y. TIMES, June 21, 1998, at 10 (discussing the way in which the Germans at first resisted relinquishing their beloved mark, but now seem to look more favorably on the euro).

[20] *See* Smallhoover & Adkins, *supra* note 15, at B13.

[21] *See* Granitsas & Islam, *supra* note 18, at 8. This concept is often referred to as "dual pricing." *See, e.g.*, Smallhoover & Adkins, *supra* note 15, at B13.

[22] *See* Granitsas & Islam, *supra* note 18, at 8.

[23] *See* John Marks, *Latest Software Nightmare: The Currency Change in Europe Could Cost U.S. Firms Billions*, U.S. NEWS & WORLD REP., Nov. 17, 1997, at 63.

[24] *See* Clifford R. Dammers, *The Euro: Eliminating Legal Uncertainty, in* THE EURO 121, 121 (Paul Temperton ed., 1997).

[25] *See* RICHARD N. CURRENT ET AL., AMERICAN HISTORY 72 (7th ed. 1987).

[26] *See id.* at 227. By 1860, over 1,500 of these state-chartered banks were in existence. *See id.* at 407.

and effectively wiped them out of existence.[27] Thereafter, the federal government dealt with currency on a national level, in part by printing paper currency referred to as greenbacks.[28] Due to the multiplicity of mediums of exchange in the United States, both during the colonial period and the 19th century, it is difficult to see how a meaningful comparison could be drawn between the stable, stalwart, and government-backed currencies of our time such as the German mark or the French franc and the disparate certificates and bank notes of the 17th, 18th, and 19th centuries. However, the printing of greenbacks with the simultaneous phasing out of the various state bank notes of disparate value certainly simplified complex American interstate business transactions. Similarly, the introduction of the euro will likely lessen the need for European businesses and investors to consider the relative value of different European currencies, freeing them up to expend energy considering other issues. Notwithstanding this, today's complex global financial, economic, and legal milieu generates and renders possible a host of issues which could not arise in the much less complicated eras of the 17th through 19th centuries.[29]

B. *Most Contracts Unaffected*

Fortunately for most financial contracts, such as mortgages and loans, few (if any) legal issues will arise due to the conversion from European national currencies to the euro.[30] For example, if a borrower obtained a promissory note in November of 1998 for DM 10,000, payable in November of 2002 with interest of 5% per annum, she must repay the lender an equivalent amount of euros when the note becomes due. All of the terms and conditions of the instrument, including the interest rate and the term of the loan, are unaffected. The obligation to pay in German marks is simply converted into euros, based on the established exchange rate.[31] From this perspective, the conversion to the euro doesn't seem to create any problems whatsoever.

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[27] *See id.* at 407; *see generally* The National Bank Act, Law of June 3, 1864, ch. 106, 13 Stat. 99 (codified as amended at 12 U.S.C. § 38 (1994)).

[28] *See* CURRENT ET AL., *supra* note 25, at 407.

[29] I do not mean to imply that the economic and legal aspects of American history do not have any instructive lessons for today. However, today's highly complex world of international business transactions, (e.g. swaps and derivatives), litigiousness, and supra-national regulation (such as by the International Monetary Fund or World Trade Organization) poses unexplored questions that have no true analog in history.

[30] *See* Dammers, *supra* note 24, at 121.

[31] For a similar example, see *id.*

C. *Types of Contracts Most Likely to be Challenged*

Despite the ease that some may feel, commentators and scholars are postulating that three specific types of contracts are likely to be challenged by one of the parties after the substitution by the euro for the former national currencies. First, one scholar asserts that long-term supply contracts might be most often called into question.[32] Such contracts probably did not anticipate the currency of payment would be changed; in fact, many of these contracts probably have no provisions in them discussing the conversion to the euro.[33] Simply substituting the euro may not be an adequate solution if the parties had made bargaining assumptions about the value of legacy currencies that no longer hold true after January 1, 1999. Second, some experts argue that royalty provisions in licensing agreements pose a significant risk,[34] presumably because they resemble the long-term supply contracts in which the currency of payment was thought to be fixed and immutable. Although further research could illumine the risks that the introduction of the euro poses on these two types of contracts, the focus of this Note will be on the risks to a third type of contract.

D. *Background on Derivatives*

There has been much speculation that certain transactions not governed by European Union law, such as swaps and derivatives, could be particularly vulnerable to litigation as a result of the new euro currency.[35] It is essential, therefore, to explore these transactions in greater detail. Derivatives are defined in economic terms as "instruments whose returns are derived from those of other instruments."[36] Indeed, the term encompasses many financial

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[32] *See* Rebecca H. Marek, Note, *Continuity For Transatlantic Commercial Contracts After the Introduction of the Euro*, 66 FORDHAM L. REV. 1985, 2002-03 (1998).

[33] *See id.*

[34] *See* John P. Dunn & Gary T. Johnson, *Euro Poses Disclosure Issues for SEC Registrants*, NAT'L L.J., Feb. 9, 1998, at B10.

[35] *See* Howard M. Liebman, *Key Considerations to be Taken Into Account in the Introduction of the Euro*, METROPOLITAN CORP. COUNS., Mar. 1998, at 10, 10. One scholar asserts that derivative contracts are the primary types of contracts that give rise to continuity of contract issues as a result of the introduction of the euro. *See* Andre Fiebig, *The Introduction of the Euro and Its Implications for U.S. Legal Practitioners*, 11 DEPAUL BUS. L.J. 257, 267 (1999).

[36] Don M. Chance, AN INTRODUCTION TO DERIVATIVES 2 (4th ed., 1998). The underlying instruments on which derivatives are based include mortgages, government-backed securities, stocks, or bonds. *See* Dominic Bencivenga, *Revisiting Derivatives: CFTC Proposal Sparks Regulatory Turf Battle*, N.Y.L.J., June 4, 1998, at 5.

instruments, including futures, options, forward contracts, and swaps.[37] Typically, there are four purposes of such instruments: 1) to lower funding costs through diversification of funding sources; 2) to enable better management of assets and liabilities; 3) to hedge against financial risks; and 4) to speculate.[38] The third purpose, hedging, concerns the purchase of an asset or a collection of assets for the purpose of reducing the risk to which another investment is exposed.[39] This ability of derivatives to protect investments from fluctuations in the market is perhaps their greatest advantage, as companies save tremendously by using them.[40] The Associated Press recently reported that "[s]udden changes in the value of the dollar since the Asian crisis began last year have played havoc with operations of companies that sell their products overseas or depend on foreign suppliers."[41] Financial lawyers must be keenly aware of financial instruments such as derivatives because they perform a vital function for many businesses.[42]

The mechanics of derivatives transactions are not as abstruse as one might think. First of all, regardless of the type of derivatives contract (e.g. swaps, futures, etc.), each transaction is exactly that — a contract between a buyer and a seller.[43] Usually an exchange of promises is made, in which the parties become obligated to exchange stated cash payments.[44] For example, suppose an automobile wholesaler, X, agrees in March to sell Audis to a retailer for £11,000,000 in October.[45] X cannot purchase the cars until October, when he will get the purchase price from the retailer. X then agrees to buy the cars for £10,000,000, payable in German marks in October from the German manufacturer. This arrangement appears reasonable. But if the value of the mark goes up by 10% between March and October, it will cost

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[37] *See* Chance, *supra* note 36, at 5; Thomas C. Singher, *Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action?* 18 FORDHAM INT'L L.J. 1397, 1400 (1995).

[38] *See* Singher, *supra* note 37, at 1405-06.

[39] *See* Gregory Connor, *Hedging*, *in* THE NEW PALGRAVE DICTIONARY OF MONEY & FINANCE 299 (Peter Newman et al. eds., 1992); *see also* THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 837 (Anne H. Soukhanov et al.eds., 3d ed., 1996).

[40] *See* Singher, *supra* note 37, at 1409.

[41] Michael White, *Currency Fluctuations Create Risk*, PITTSBURGH POST-GAZETTE, Dec. 17, 1998, at D6.

[42] *See generally* Schuyler K. Henderson, *Derivatives Law as a Niche Area is Dead*, 9 J. INT'L BANKING L. 351, 354-57 (1997) (arguing in part that knowledge of derivatives law will be key to any financial lawyer's practice in the future).

[43] *See* Chance, *supra* note 36, at 5.

[44] *See* Singher, *supra* note 37, at 1401.

[45] For an example similar to this one, see ROBERT P. ROTELLA, THE ELEMENTS OF SUCCESSFUL TRADING: DEVELOPING YOUR COMPREHENSIVE STRATEGY THROUGH PSYCHOLOGY, MONEY MANAGEMENT, AND TRADING METHODS 47 (1992).

£11,000,000, thereby wiping out X's profit. If the mark does especially well, then X could even lose money on the transaction! On the other hand, X could also make a profit on the deal if the value of the mark decreases. X's goal is not to speculate on the variable foreign exchange rate of the mark and the pound. X would rather use some transaction to hedge the risk he faces vis-à-vis the foreign exchange rate. X reckons that he should buy £10,000,000 in marks on the futures market in order to ensure that he will get his £1,000,000 profit. X enters into a futures contract in March with Y, a commercial bank, such that the parties agree to exchange X's £10,000,000 to marks in October, at an exchange rate they specify at the time of contracting. Amazingly, X has locked in his profit that previously was vulnerable to exchange rate fluctuations. This example demonstrates that the value of the futures contract hinges on both the value of the payments made and the value of the underlying exchange rate between the pound and the mark.[46]

Contracts such as this are thought to be vulnerable to litigation because they either specify legacy currencies or refer to interest rates that are linked to legacy currencies. Since the underlying purpose of these contracts might be frustrated by the creation of a supra-national currency, one party could attempt to void the contract. Despite the skepticism and incredulity of some towards these assertions, the legal community is taking these potential risks very seriously.

E. *Arguments to Excuse Performance*

One of the arguments legal experts have anticipated in connection with any discussion of the euro and the effect of its introduction on certain contracts involves impossibility or extreme impracticability of performance. If a fundamental contract term ceases to exist, or when a contract cannot be performed in a practical way due to the disappearance of a price term, a party might be excused from performance.[47] Although the traditional American common law approach was not to excuse performance of the parties, even when it became overly onerous,[48] some courts have decided that when performance is particularly burdensome, it is equitable to excuse a party.[49] Thus, a disadvantaged party could try to argue that the introduction

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[46] *See* Singher, *supra* note 37, at 1401.

[47] *See* Dammers, *supra* note 24, at 122.

[48] For a classic example of the failure of the impracticability defense, see International Paper Co. v. Rockefeller, 161 A.D. 180 (N.Y. App. Div. 1914) (rejecting the defendant's impracticability defense, which was predicated upon the heightened cost of performance due to a fire).

[49] Successful uses of this argument can be found in the common law. *See, e.g.*, Mineral Park Land Co. v. Howard, 172 Cal. 289 (Cal. 1916).

of the euro results in changed circumstances that justify the excuse of their contractual obligations.[50]

Impossibility or extreme impracticability are not likely to be winning arguments for parties to derivatives contracts, for many reasons. First, the conversion from many European currencies to a single European currency is a foreseeable event that tends to negate the notion that the parties entered into the contract unaware that such an event could substantially change an essential part of their bargain. Secondly, while it may be true that German marks and Italian lira will soon cease to exist, another currency will be taking their places. While it may be strictly impossible to perform a derivatives contract after a certain date by referring to rates of deposit expressed in the legacy currencies, parties can substantially perform by referring to the new and perfectly commercially acceptable euro currency. As one commentator has said, "[t]he substitution does not make performance of the payment obligation impossible. It permits performance by a substitute method."[51] Courts would be unlikely to excuse performance of derivatives contracts based solely on the argument that the introduction of the euro renders performance of contracts containing references to rates of deposit expressed in legacy currencies extremely impracticable or impossible.

A second argument might be brandished by parties seeking to escape derivatives contracts after the euro has been introduced. American case law demonstrates that an unforeseen event nullifying the fundamental purpose for performing a contract can void a party's duty of performance.[52] This argument does not hinge on the fact that the contract cannot literally be performed. Instead, it revolves around whether an event such as the introduction of the euro currency could frustrate one party's fundamental reason for entering into the contract in the first place. Moreover, the Restatement of Contracts has affirmed this case law through section 265:

> Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary.[53]

The United States isn't the only jurisdiction where the threat of litigation concerning frustration of purpose has been anticipated. English law

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[50] *See* Marek, *supra* note 32, at 2003.

[51] Michael Gruson, *The Introduction of the Euro and its Implications for Obligations Denominated in Currencies Replaced by the Euro,* 21 FORDHAM INT'L L.J. 65, 92 (1997).

[52] *See id.* at 93 (citing Bank of America Nat'l Trust and Savings Ass'n v. Envases Venezolanos, S.A., 740 F. Supp. 260, 266 (S.D.N.Y. 1990).

[53] RESTATEMENT (SECOND) OF CONTRACTS § 265 (1981).

provides that any event that makes a contract impossible to fulfill can legally frustrate it.[54] Moreover, even E.U. legislation allows for claims of frustration when an event "fundamentally alters the contract's commercial nature."[55] Although such an argument may not persuade a court when a simple contract is involved, more complex and varying circumstances might persuade a court to agree with it.

IV. LEGISLATIVE AND CONTRACTUAL RESPONSES TO CONTRACTS DENOMINATED IN LEGACY CURRENCIES

Many countries have taken action of some form or another regarding the continuity of contracts during and after the substitution of the euro for the previous legacy currencies. No attempt is made here to address all of them. Rather, a few representative legislative responses have been culled out for examination.

A. *European Community Law*

There are two specific pieces of European Union legislation that have been written to address the legal framework for the introduction of the euro.[56] The first one was enacted in 1998[57]pursuant to Article 1091(4) of the Maastricht Treaty,[58] and is sometimes referred to as the "Article 1091(4) Regulation"[59] (Regulation 1091(4)). The second piece of legislation is referred to as Council Regulation 1103/97 (Regulation 1103/97), and was passed pursuant to Article 235 of the Treaty establishing the European Community on June 17, 1997.[60] Both of these regulations perform critical functions in the European Commission's effort to minimize legal problems resulting from the introduction of the single currency.

[54] *See* Wolfgang Munchau, *European Age of Uncertainty,* FIN. TIMES (London), Mar. 25, 1997, at 30; Smallhoover & Adkins, *supra* note 15, at B13.

[55] Smallhoover & Adkins, *supra* note 15, at B13.

[56] Jan Meyers & Damien Levie, *The Introduction of the Euro: Overview of the Legal Framework and Selected Legal Issues*, 4 COLUM. J. EUR. L. 321, 335 (1998).

[57] *See* Council Regulation 974/98 of 3 May 1998 on the Introduction of the Euro, 1998 O.J. (L 139) 1-5, [hereinafter Council Regulation 974/98].

[58] *See id.*; Resolution of the European Council of July 7, 1997 on the Legal Framework for the Introduction of the Euro, 1997 O.J. (C 236) 7.

[59] *See, e.g.,* THE EURO app. at 275 (Paul Temperton ed., 1997).

[60] *See* Dammers, *supra* note 24, at 122; Council Regulation No. 1103/97 of 17 June 1997 on Certain Provisions Relating to the Introduction of the Euro, 1997 O.J. (L 162) 1, 1 [hereinafter Council Regulation 1103/97].

1. Regulation 1091(4)

It may not be clear to the reader why the European Commission needed two different regulations to accomplish similar legislative goals. The European Commission sought to find a legal foundation for its regulations in Article 1091(4) of the Maastricht Treaty,[61] which permits the adoption of "measures necessary for the rapid introduction of the euro."[62] That article, however, requires the participating member states to be ascertained in order for it to form the legal basis of subsequent legislation.[63] Subsequently, the Commission divided up the legal framework into two sections: one to be based on Article 235, thereby allowing swift action on certain pressing legal matters, even in the absence of a clear determination of the participating member states, and the other to be based on Article 1091(4) of the Maastricht Treaty for issues not of a pressing nature.[64]

Regulation 1091(4) has several important effects. First, Article 2 and Article 3 establish that the euro will be the currency for participating European States and that the national currencies will in effect be substituted by the euro currency according to the conversion rates.[65] Second, Article 6 of the regulation provides the following vis-à-vis the transition period between January 1, 1999 and January 1, 2002: "Where in a legal instrument reference is made to a national currency unit, this reference shall be as valid as if reference were made to the euro unit according to the conversion rates."[66] Thus, legal instruments such as contracts can refer to either the euro or the national currencies during the transition period. Parties can denominate in euro amounts, because the euro has been established as the currency of the European Member States under Article 2.[67] Parties can also denominate their contracts in national or legacy currency amounts, because Article 6 validates such references as if they were made in the new euro currency.[68] For contracts that are entered into before January 1, 1999, any amounts in national currencies will not be altered, since parties are still free to specify amounts in national currencies throughout the transition period ending January 1, 2002.[69] However, Article 14 provides that after the transition period ends, references in new contracts to amounts in national

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[61] *See* European Commission, *Legal Framework for the Use of the Euro,* EURO PAPERS, Sept. 1997, at 2.

[62] *See* Treaty on European Union, art. 1091(4), 1992 O.J. (C 191) 1, 21.

[63] *See id.*

[64] *See* European Commission, *supra* note 61, at 2.

[65] *See* Council Regulation 974/98, *supra* note 57, arts. 2, 3.

[66] *Id.* art. 6(2).

[67] *See* European Commission, *supra* note 61, at 3-4.

[68] *See* Council Regulation 974/98, *supra* note 57, art. 6(2).

[69] *See* European Commission, *supra* note 61, at 4.

currency units will be viewed as references to the euro.[70] Although not a complete handbook of laws regarding the effects of the new currency on contracts, Regulation 1091(4) establishes a few foundational ideas upon which other laws can be based.

2. Regulation 1103/97

As mentioned previously, Regulation 1103/97 was enacted in an expeditious fashion, in order to allay the urgent fears of those in the financial markets who demanded a greater level of legal certainty and transparency regarding the introduction of the euro and its consequences.[71] It is binding upon all European Union members, regardless of whether they adopt the single currency or retain their own national currencies.[72]

Article 3 of this regulation provides that the introduction of the euro will neither: 1) modify any term of a legal instrument; 2) excuse the performance of any party under any legal instrument; nor 3) grant a right to a party to modify or terminate any legal instrument.[73] Also of critical import in Regulation 1103/97 is the Council's definition of "legal instrument" which explains the term as "legislative and statutory provisions, acts of administration, judicial decisions, contracts, unilateral legal acts, payment instruments other than banknotes and coins, and other legal instruments with legal effect."[74] Some commentators state that this definition was intentionally broad, in order to include all types of contracts and agreements.[75] In a similar vein, Article 3 also provides that this continuity of contract provision is "subject to anything which parties may have agreed."[76] As a result, parties can override the continuity of contract clause of Article 3 by modifying their contracts to fit their own special circumstances.[77]

B. New York State

In 1997, the New York legislature amended its General Obligations Law, also known as Title 16, to address the continuity of contract issue vis-à-vis the introduction of the euro.[78] It provides that the euro is deemed a "commercially reasonable substitute and substantial equivalent" whenever

[70] *See id.* at 7.

[71] *See* Dammers, *supra* note 24, at 122; European Commission, *supra* note 61, at 7.

[72] *See* Munchau, *supra* note 54, at 30.

[73] *See* Council Regulation 1103/97, *supra* note 60, art. 3.

[74] *Id.*,art 1.

[75] *See* Dammers, *supra* note 24, at 123.

[76] *See* Council Regulation 974/98, *supra* note 57, art. 8.

[77] *See* Meyers & Levie, *supra* note 56, at 340.

[78] *See* Gruson, *supra* note 51, at 100.

contracts refer to a legacy currency that has been replaced by it.[79] Moreover, the law also provides that the introduction of the euro does not trigger discharge or excuse of performance obligations under any contract, or "give a party the right to unilaterally alter or terminate any contract, security or instrument."[80] The rule applies to situations where a party pays an obligation in euros, but the debt was specified in a currency which was replaced by the euro. It also applies when a security or instrument makes "reference to [an] interest rate or other basis [that] has been substituted or replaced due to the introduction of the euro and that is a commercially reasonable substitute and substantial equivalent."[81] Section 5-1603 ensures that agreements between parties to a contract regarding the introduction of the euro and its effect will not be altered by Title 16.[82] Finally, the law also provides in section 5-1604 that Title 16 applies to all contracts with respect to commercial transactions, including securities.[83]

Other states have also dealt with this issue, most notably Illinois and California. The Illinois statute is almost identical to the New York law,[84] while the California law omits only two provisions contained in the laws of New York and Illinois.[85] The differences that exist are not significant because the essential provisions of all three states' laws are practically identical.

C. Protocol by the International Swaps & Derivatives Association (ISDA)

The International Swaps & Derivatives Association is an association of financial institutions that transact business involving swaps agreements and derivatives contracts.[86] The ISDA designed a new industry guideline, called the EMU (European Monetary Union) Protocol (the Protocol), which establishes a standard and quick system to allow parties to change the terms to which they agreed.[87] The Protocol is designed for all banks, corporations, governments, investment firms, insurance companies, and others who are parties to swaps or derivatives contracts already governed by other ISDA

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79 N.Y. GEN. OBLIG. LAW § 5-1602(1)(a) (McKinney Supp. 1999).

80 *Id.* § 5-1602(2).

81 *Id.*

82 *See id.* § 5-1603.

83 *See id.* § 5-1604.

84 *See* Euro Conversion Act, 815 ILL. COMP. STAT. ANN. 617/10-617/30 (West Supp. 1999).

85 *See* CAL. CIV. CODE § 1663 (West Supp. 1999).

86 *See* Schuyler K. Henderson, *Swap Credit Risk: A Multi-Perspective Analysis, in* CURRENT DEVELOPMENTS IN INTERNATIONAL BANKING AND CORPORATE FINANCIAL OPERATIONS 40, 47 (Koh Kheng Lian et al. eds., 1989).

87 *ee* Bencivenga, *supra* note 36, at 5.

agreements.[88] By participating in this Protocol, parties to derivatives contracts are in essence amending existing contracts to account for the new currency.[89]

The Protocol accomplished several objectives. First, it provides that contracts already in force will continue to be honored, even though the euro will replace eleven European currencies.[90] Second, the Protocol will also create five "fallback methods" to be used by the parties to decide upon new price sources when the legacy currencies disappear.[91] For example, when a derivatives contract specifies a rate for deposits in a legacy currency, a fallback provision is needed once the rate is no longer available. In this case, the first fallback provision will allow parties to use rates for deposits in euros, if they appear on the same page on which the previous rates were listed.[92] Third, in addition to fallback provisions, the Protocol also reiterates that by agreeing to abide by it, parties incur valid and binding legal obligations.[93]

V. EVALUATION OF THE LAWS

A. *Necessity of Legislation*

Arguments can be made for and against the necessity of pieces of legislation such as Regulation 1103/97 and section 5-1602 in New York. Before these arguments are considered, it is important to discuss some of the basic policy objectives that laws such as these might address. The law is not an end in itself; compelling reasons do exist for having it. From an economic perspective, market agents need clear signals about how the law will handle certain contractual issues.[94] If market agents lack such assurances, market failures and higher transaction costs could result.[95] Similarly, parties to

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[88] *See* International Swaps and Derivatives Association, Inc., *EMU Protocol FAQ's* (visited Feb. 6, 1999) <http://www.isda.org/emufaq> (providing a primer for all those interested in the Protocol, its mechanics and provisions, and how to participate in it).

[89] *See id.*

[90] *See* Bencivenga, *supra* note 36, at 5.

[91] *See id.* International Swaps & Derivatives Association., Inc., *EMU Protocol,* Annex 2 (visited Sept. 12, 1999) <http://www.isda.org/emutext.html> (acknowledging that the introduction of the euro might cause the underlying rates, upon which many derivatives contracts are based, to be unavailable and listing the various fallback provisions).

[92] *See id.*

[93] *See id.* § 3(e).

[94] *See* European Commission, *supra* note 61, at 8.

[95] *See* Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269, 282 (1986) (arguing in part that the acts of government legal institutions can be

contracts (such as market participants and governments) should be afforded greater transparency of the law whenever questions exist regarding how the law will treat an issue. Otherwise, there could be a reluctance to enter into contracts at all, or alternatively a persistent worry that contracts might not be enforceable. However, sometimes parties can create private strategies that can substitute for the law and the legal system in an efficient way.[96] The law must be careful, therefore, not to intervene when private strategies alone can bring about efficiency.

Few (if any) scholars or commentators criticize the European Council's decision to adopt a regulation setting up the legal framework for the new euro currency. After all, such a law is justified under the principle of *lex monetae*, which establishes that all nations as a sovereign matter can change their currency, and other nations must honor any such change.[97] On that basis, it is in Europe's interest to adopt laws regarding its new currency, such that a *lex monetae* will exist to which courts may turn for guidance regarding contractual issues.[98] It was theoretically possible for Europe to adopt its common currency without having legislated on the matter of contractual continuity. However, European monetary union entails many different nations agreeing to adopt a common currency. The substantive civil (or common) law of contracts in those nations likely contains many variations, such that claims of frustration, impracticability, etc. could have varying degrees of success, depending on where in the European Union parties litigate. For this reason, it was vital for the European Council to send a clear signal that the introduction of the euro would not trigger such contract doctrines as frustration of purpose or impracticability. If such a law did not exist, there would be a great possibility for market failures, since parties would be much more reluctant to enter into contracts and higher transaction costs would have to be paid, in terms of bargaining and negotiation to ensure enforceability. Along these lines, market participants that face higher transaction costs might decide to deal with those negative externalities by shifting those costs to others, which can also lead to market failures. Without the law, financial institutions could face an adverse selection problem, in that they will feel constrained to be more cautious in

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responsible for increasing transaction costs, thus discouraging parties to enter into contracts).

[96] *See, e.g.,* Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525, 544-45 (1993) (arguing in part that nonmarket institutions can be successful in making market transactions efficient even in the absence of a law-supplied rule).

[97] *See* Dammers, *supra* note 24, at 121.

[98] The principle of *lex monetae* applies also to cases where many countries adopt a common currency, because the nations are still exercising sovereign rights to change their currencies, even if one common currency results.

"writing a contract."[99] However, with the law, the legal risks to parties such as financial intermediaries are decreased, thereby giving them a greater incentive to participate in such transactions. Therefore, the necessity of continuity of contract legislation in Europe is not questioned very much.

However, in non-European Union jurisdictions, scholars and commentators are divided about the need for continuity of contract laws to address the introduction of the euro. Many agree that outside the European Union, common law contract principles such as frustration, impracticability, or impossibility will not trigger excuse or discharge of contractual obligations due to the conversion of the price term from national currency units to euro units.[100] This ought to placate the market, one might think. Moreover, the doctrine of *lex monetae* is accepted in jurisdictions of the main financial centers of the world.[101] Those centers have a vested interest in the recognition of the euro and the preservation of existing and future contracts that denominate amounts in euros as well as legacy currencies.[102] These considerations support the notion that continuity of contract legislation is wholly unnecessary outside the European Union, a position that at least one scholar has taken.[103] However, other commentators argue that any level of uncertainty about the continuity of contracts denominated in euros or replaced European currencies is unacceptable to the financial markets of the world.[104] The Financial Law Panel, a London-based group, has concluded that despite the existence of regulations in the European Union to address the continuity of contracts, under existing law, Singapore courts would be particularly reluctant to enforce contracts denominated in legacy currencies.[105] Where does this leave us, then?

The laws that have been enacted by New York and other jurisdictions in response to the Euro threat are necessary, despite the fact that ordinary contract principles will probably not allow parties to escape their contractual obligations. Many (if not most) parties admittedly will not even consider trying to avoid their contractual obligations simply because the agreed-upon

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[99] In this case, banks play the role of speculator in which they are the ones assuming the risk. That is what is meant by "writing a contract."

[100] *See* Meyers & Levie, *supra* note 56, at 341-42; Gruson, *supra* note 51, at 95.

[101] *See* European Commission, *supra* note 61, at 9.

[102] *See id.* "The continuity issue is of utmost concern to participants in international financial markets, where the equivalent of trillions of dollars are transacted electronically every day." James H. Freis, Jr., *Continuity of Contracts After the Introduction of the Euro: The United States Response to European Economic and Monetary Union*, 53 BUS. LAW. 701, 702 (1998).

[103] *See* Gruson, *supra* note 51, at 105-06.

[104] *See* Meyers & Levie, *supra* note 56, at 341-42.

[105] *See* Freis, *supra* note 102, at 707-08 (citing FINANCIAL LAW PANEL, ECONOMIC AND MONETARY UNION: CONTINUITY OF CONTRACTS OUTSIDE THE EUROPEAN UNION, THE POSITION UNDER THE LAW OF SINGAPORE 22 (July 1998)).

price term or reference rate of deposit is being converted to euro units. After all, parties enter into contracts because they believe they will receive a gain as a result. However, some parties will be disadvantaged by changing circumstances that were unknown at the time of contracting. Some will argue to escape their contracts, and some are probably going to use the introduction of the euro as a basis for their argument. The law should not accept this argument. Although some contracts are more susceptible to this type of argument than others, derivatives contracts are especially vulnerable. Parties to such contracts must be protected. When high stakes are involved, even a small amount of uncertainty in the parties' minds could cause them to avoid the perceived risky transaction. This result is unacceptable because the benefit to businesses that derivatives contracts provide is indispensable to our economy. Granted, the swaps and derivatives markets have only relatively recently assumed greater prominence and influence in the global economy.[106] Yet, a jurisdiction's failure to enact legislation to allay the fears of those in this growing sector of the financial world could send a signal that such contracts may or may not be revocable. For these reasons, it is vital to have legislation to ensure the enforceability of contracts affected by the introduction of the euro.

B. *Adequacy of Legislation*

The laws enacted by the European Council and the states of New York, Illinois, and other jurisdictions adequately protect parties to most contracts. The introduction of the euro does not change the commercial rationale in those instances; the new currency is only of incidental import.

Notwithstanding this, other contracts (such as derivatives contracts) do have a commercial rationale that is considerably affected by a change in the currency unit. A buyer may have chosen to enter into a certain transaction for the purpose of hedging against fluctuations in the value of the mark. The seller, meanwhile, may have considered the market and decided that the transaction would turn out profitable to her. When the time comes for performance, the buyer may discover that the benefit of his bargain has been stripped away by the conversion of the marks into perceived weaker euros. Given the loss felt by the buyer, he will seek to avoid this result by bringing an action to rescind the contract because it has been frustrated due to the introduction of the euro. These specialized contracts might then legitimately be frustrated in some sense by the currency change, and courts might decide to discharge the contractual obligations of the parties, since the claim of frustration has more legitimacy.[107] Since this very real possibility exists in

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[106] *See generally* J. ORLIN GRABBE, INTERNATIONAL FINANCIAL MARKETS 26-27 (3d ed. 1996) (providing a brief financial and economic world history from 1973 to the globalization of economies in the 1990s).

[107] *See* Smallhoover & Adkins, *supra* note 15, at B13.

the context of derivatives transactions notwithstanding the existing legislation, the issue must be addressed in some fashion.

While the current euro conversion laws technically are meant to apply to all contracts, the provisions are inadequate to protect parties to derivatives contracts. As discussed in Part IV, the International Swaps & Derivatives Association has created a Protocol in response to this deficiency, instituting a framework within which parties can determine new price sources when the currencies mentioned in their contracts cease to exist as such.[108] Parties that adhere to the Protocol now can feel secure that their contracts, as amended, have resolved the issue. That contractual solution holds much promise for resolving legal ambiguity. Yet, this Protocol may not be enough to persuade prospective parties that it is safe to enter into derivatives contracts. Without specific legislation to address the dangers perceived by the market, this lack of transparency could lead to inefficient, undesirable results. The high cost of determining whether derivatives contracts are enforceable could deter parties from pursuing them at all. Moreover, ambiguity in the law could induce some to speculate in derivatives contracts involving European currencies in a way that reflects a moral hazard. Despite the fact that the ISDA Protocol is an industry standard, there are bound to be free riders who will try to avoid its reach, and renege on their contractual agreements. Although the ISDA Protocol provides a helpful means by which parties can reform their contracts, it does not completely solve the larger problems of transparency and inefficiency that need to be resolved through more specific legislation.

VI. AN APPEAL TO LAWMAKERS AND LAWYERS

First, other jurisdictions should adopt laws at least as specific as Regulation 1103/97 and section 5-1602 of the New York statute. Legislative bodies in New York, Illinois, and the European Union have at least addressed this important issue to some degree, and other states should follow suit. Moreover, it is appropriate for all countries to legislate in this area, as financial markets are becoming more and more global. No country should consider itself unaffected by this conversion; the law should guard against litigation risks like these, no matter how remote they may seem to be. At some point, parties outside the jurisdictional bounds of New York or the European Union might be faced with a dispute like this, and they will either be relieved to discover that thoughtful legislators passed a law to protect them, or they will be furious to discover that parties in other nations are protected, while they are not. However, countries like Japan, China (Hong Kong), Singapore, and Bahrain face the greatest risk of litigation, due to their status as financial and eurocurrency centers.[109]

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[108] *See* Bencivenga, *supra* note 36, at 5.

[109] *See* GRABBE, *supra* note 106, at 219-21.

Second, wherever derivatives, swaps, and similar financial agreements are executed, there is an even greater need for the law to protect the parties against claims of impossibility and frustration of contract. It would be appropriate for lawmakers who are still considering the adoption of legislation to address the continuity issue specifically as it pertains to these transactions. Agreements like the EMU Protocol concerning continuity of contracts play an important role in soothing the fears of banks and companies that use these agreements to hedge against currency market fluctuations. Undoubtedly some parties may choose to adhere to the Protocol, while others might find an alternative solution. However, although an industry standard and a binding obligation among those who adhere to it, the Protocol does not carry the force of law. It would be better if euro conversion statutes adequately discouraged renegade derivatives dealers from taking advantage of gaps in the law, by specifically codifying provisions such as those in the Protocol. Only in that way can the market properly limit the free rider problem that may result.

Third, whenever state law (or federal law, where applicable) is unclear about the enforceability of contracts during and after the transition to the euro, lawyers for affected parties should try to revise their contracts to prevent issues from arising.[110] Indeed, lawyers have argued that companies should not trust law making bodies to enact laws that will protect them, because inevitably some parties will view the euro conversion as an opportunity to escape contractual agreements.[111] Although the law acts as a safeguard for parties that have not contemplated the law, it would be more efficient in some cases for parties to expend resources through transaction costs in order to gain the benefit of greater certainty that their bargain will be enforceable. Lawyers for companies using derivatives contracts should be ready to advise them in these matters and assist them in drafting appropriate contract clauses, such that legal uncertainty can be minimized.

VII. CONCLUSION

Although most discussions of European monetary union assume that the venture will be a success, doubters and critics vociferously disagree. One skeptic has said that "[m]onetary union is a crazy project. It creates deflation. That's why the currency will be a disaster."[112] Some fear exists that the euro could collapse and thereby trigger a worldwide financial and trade crisis.[113] Holders of euros in that case would then rush to unload their euros and buy dollars.[114] Such a currency failure could herald a step back for

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[110] *See* Dunn & Johnson, *supra* note 34, at B10.

[111] *See* Geanne Rosenberg, *Liability May Lurk in Euro Conversion*, NAT'L L.J., June 1, 1998, at B1.

[112] Peterson, *supra* note 13, at 94 (quoting Emmanuel Todd, a French philosopher).

[113] *See* Garten, *supra* note 5, at 30.

a Europe trying to overcome its tumultuous history of tension and national rivalries.[115]

As we wait to see the full impact of the euro on the world, lawmakers and lawyers need to be addressing key contractual issues, in order to ensure that potential negative scenarios envisioned by skeptics are not further complicated by their failure to act.

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[114] *See id.*

[115] *See id.*