Florida Journal of International Law

Volume 12 | Issue 3 Article 5

January 1999

The Effect of the Introduction of the Euro on Continuity of Contracts: Is the United States Prepared

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CASE COMMENTS

THE EFFECT OF THE INTRODUCTION OF THE EURO ON CONTINUITY OF CONTRACTS: IS THE UNITED STATES PREPARED?

*Nonna K. Crane**

I. INTRODUCTION

Eleven states took an unprecedented step on January 1, 1999 when they joined the third stage of the European Monetary Union, adopting the single currency, the euro.[1] Along with many benefits of uniform money came a significant potential legal issue — continuity of contracts.[2] The goal is that

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* I dedicate this comment to my husband, Scott Crane, for his amazing love and support, and to my parents, Andrei and Rimma Klimchenkov, who taught me that life is beautiful. I would also like to thank Professor Danaya Wright for her assistance.

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

2. *See* Rebecca H. Marek, *Continuity for Transatlantic Commercial Contracts After the Introduction of the Euro*, 66 FORDHAM L. REV. 1985, 2008 (1998) (arguing that contracts not governed by the laws of states that have not passed legislation protecting the continuity of contracts may be vulnerable to judicial intervention and discharge).

when the euro replaces the national currency of a participating state, the substitution will not result in termination of contracts in which debt is denominated in the replaced currency.[3]

This comment examines how the European Union addresses the problem of continuity of contracts. This comment analyses the approaches to this problem in the United States and examines alternative solutions. This comment shows that, while the measures adopted in the United States ensuring that legal instruments will not be disturbed are helpful and necessary steps, they may not be sufficient to deal with the grand scale of the European monetary project.

II. BACKGROUND AND HISTORY

A. *History of the Euro: An Overview*

The first plan for a European monetary union was proposed in 1970 by Pierre Werner, prime minister and finance minister of Luxembourg, who chaired a group of experts responsible for designing a monetary union for the European Community (EC) governments.[4] The Werner report contemplated introduction of a single currency by 1980.[5] With the collapse of the Bretton Woods system,[6] a major oil crisis, and increased inflation, the Werner plan fell through.[7]

In 1979, the European Economic Community introduced the European Monetary System (EMS) to enhance stability of exchange rates within the European Union.[8] During the ensuing decade the system succeeded in keeping the currency variations stable.[9] Thus, a relatively stable foundation was created for implementation of the monetary union. In 1989, a report presented by Jacques Delors, the president of the EC Commission, made

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3. *See* Ruth Finch & Chris Ffinch, *European Monetary Union Raises Contract Issue*, Nat'l L.J., Mar. 4, 1997, at B10 (pointing out that continuity of contracts has been identified as possibly the most important legal issue regarding the EMU).

4. *See* PETER B. KENEN, ECONOMIC AND MONETARY UNION IN EUROPE 4 (1995).

5. *See id.* at 5.

6. The agreement signed at Bretton Woods after the Second World War was designed as a mechanism for pegging the exchange rates: the currency of the International Monetary Fund participants was to be denominated in terms of gold or the American dollar. It functioned until 1971 when the link between gold and the U.S. dollar was suspended. *See* Christopher Taylor, *Introduction: The Economics and Politics of EMU, in* EMU EXPLAINED 28 (Ruth Pitchford & Adam Cox eds., 1997); *see also* FREDERICK A. MANN, THE LEGAL ASPECT OF MONEY 31 (1982).

7. *See* KENEN, *supra* note 4, at 5-6.

8. *See* DAVID CURRIE, THE PROS AND CONS OF EMU 17-21 (1997) (explaining that an exchange rate mechanism is required to keep currency variations of participating states to a minimum).

9. *See id.* at 20.

a specific proposal for monetary unification, and this proposal became the foundation for the Maastricht Treaty of 1992.[10]

B. *Implementation of the Euro: A Three Stage Plan*

The Maastricht Treaty called for the EU Member States to establish an economic and monetary union (EMU).[11] The Treaty established the European Monetary Institute (EMI), a legal entity responsible for preparing, coordinating, and supervising the Member States in their transition to the single monetary system.[12] The Treaty introduced a three-stage plan under which Member States with low inflation and healthy public finances would eventually adopt a single currency, the euro, and a single monetary policy governed by a common authority, the European Central Bank (ECB).[13]

As of January 1, 1999, the euro became the common currency of the eleven initial EMU participants[14] and replaced their existing national currencies at fixed conversion rates.[15] During the transitional period from January 1999 to December 2001 euros will exist along with national currencies and economic agents are free to use either the euro or the national currency.[16] In the first half of 2002, the economy will switch to the euro and references to the national currency units in legal instruments will "have to be read as references to the euro unit, according to the conversion rates."[17]

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10. *See* KENEN, *supra* note 4, at 11-18 (discussing the report in detail and comparing it to the Werner report).

11. *See* TREATY OF THE EUROPEAN UNION AND FINAL ACT, Feb. 7, 1992 O.J. (C224) 1 (1992), 31 I.L.M. 247 [hereinafter MAASTRICHT TREATY].

12. *See id.* at 272-73.

13. *See* Jan Meyers & Damien Levie, *Legal Framework: The Introduction of the Euro: Overview of the Legal Framework and Selected Legal Issue*, 4 COLUM. J. EUR. L. 321, 322 (1998) (discussing stages of the process by which the monetary union is being brought about).

14. According to existing estimations, these States include close to 300 million inhabitants, account for 19.4% of the world's GDP, and 18.6% of the world trade compared with 19.6 % GDP and 16.6% of world trade for the United States. *See* Robert A. McTamaney & Kirstin T. Knight, *The Year of the Euro Approaches: 1999 Will Bring Currency Debut*, N.Y. L. J., Apr. 1998, at S3.

15. *See* Stephen Revell & Julia Randell Khan, *Various Measures Will Cushion the Euro's Impact on Transactions, But Some Problems Still Remain*, LEGAL TIMES, Feb. 8, 1999, at S30.

16. *See* Commission of the European Communities, The Legal Framework for the Use of the Euro: Questions and Answers on the Euro Regulations, Euro Papers, No. 10, Dec. 1997, at 2, *available in* <http://europa.eu.int/euro> [hereinafter Euro Paper No. 10]. The "no compulsion/no prohibition" principle means that the national legislation cannot interfere with the liberty to contract in terms of either the euro or the national currency. *See id.* at 13. Even if national legislation is introduced requiring certain contracts to be made in the national currencies, the parties are free to deviate from it. *See id.*

17. *Id.*

The introduction of the euro is governed by two Council regulations.[18] The Council Regulation on the Introduction of the Euro, adopted on May 3, 1998 provides that the euro will be the currency of the participating Member States and that their national currencies will be replaced with the euro over a maximum period of three-and-one-half years beginning on January 1, 1999.[19]

A second Council regulation adopted in June 1997 is based on Article 235 of the Maastricht Treaty.[20] It confirms the principle of continuity of contracts affected by the substitution of the euro for national currencies and replaces the ECU with the euro in legal instruments.[21] Both regulations have authority of law within the Member States without the need for further national legislation.[22]

III. ANALYSIS

A. *The Status Quo*

Article 3 of Regulation 1103/97 states that "subject to anything which the parties may have otherwise agreed, the introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate such an instrument."[23] The main goals of Regulation 1103/97 are to ensure that contracts will not be disturbed by the introduction of the euro, to confirm the rights and obligations under legal instruments denominated in the currency of Participating Member States, and to guide the changeover to the euro, focusing on the rules for conversion and rounding.[24] The clearly stated and binding rule of continuity of contracts is meant to preclude any attempts to rescind or cancel contract performance under theories of frustration,

18. *See id.*

19. *See* Council Regulation 974/98, *supra* note 1. The Regulation stipulates that one euro will be divided into one hundred cents and it will become the unit of account for the ECB. *See id.* at 3.

20. *See* Euro Paper No. 10, *supra* note 16, at 1.

21. *See* Council Regulation 1103/97 of June 17, 1997 on Certain Provisions Relating to the Introduction of the Euro, 1997 O.J. (L 162) 1 [hereinafter Council Regulation 1103/97].

22. *See* Meyers & Levie, *supra* note 13, at 335 (discussing the council regulations governing introduction of the euro).

23. Council Regulation 1103/97, *supra* note 21, at 2.

24. *See* Werner Van Lembergen & Margaret G. Wachenfeld, *Economic and Monetary Union in Europe: Legal Implications of the Arrival of the Single Currency*, 22 FORDHAM INT'L L.J. 1, 46 (1998). The regulation was to deal with widespread fear in the financial markets and the business community that the replacement of national currencies with the euro would provide a legal basis for termination or modification of existing contracts and provoke extensive litigation with regard to contracts that were no longer as advantageous under the terms of EMU. *See id.*

impossibility, material alteration of terms, or inequity.[25]

However, the Community itself was forced to recognize that the authority of Regulation 1103/97 does not extend outside the EU.[26] Outside of the EU, all legal jurisdictions including the United States are faced with the problem of protecting contracts.[27] In the United States, the problem is exacerbated because contracts are governed by the laws in the individual states. To address the problem, California, Illinois, Michigan, New York, and Pennsylvania introduced legislation that provides for the continuity of contracts subject to the law of these states.[28] These "Euro Statutes" are substantially equivalent to Regulation 1103/97. These state laws define the meaning of the "Euro," "Introduction of the Euro," and "European Currency Unit" ("ECU").[29] These "Euro Statutes" make it clear that the introduction of the euro will not excuse performance under any contract, security, or investment, or give rise to a right of termination.[30] Specifically, the statutes address the following areas: introduction of the euro, use of the euro in affected obligations, calculating the value in affected obligations, and using substitute references to calculate interest rates when the previous references are no longer usable due to the introduction of the Euro.[31] Despite inevitable discrepancies[32] with the EU regulation, these statutes

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25. *See* Roger J. Goebel, *Legal Framework: European Economic and Monetary Union: Will the EMU Ever Fly?*, 4 COLUM. J. EUR. L. 249, 317 (1998) (arguing that the Regulation will provide clear guidance and help to avoid unnecessary litigation).

26. *See* Euro Paper No. 10, *supra* note 16, at 9. A response to a concern about continuity of contracts under the laws of the non-EU countries included a statement that these jurisdictions have an interest in recognizing the euro and will take necessary steps to increase legal certainty. *See id.*

27. *See* McTamaney & Knight, *supra* note 14, at S4 (arguing that in the U.S. the problem is further complicated by the existing case law allowing for unenforceability of a contract where an intended pricing mechanism is no longer available).

28. *See* CAL. CIV. CODE § 1663 (1999); 815 ILL. COMP. STAT. 617/15 (West 1998); 1998 MICH. PUB. ACTS 394; N.Y. GEN. OBLIG. LAW § 5-1601 (Consol. 1999); 1998 PA. LAWS 122 [hereinafter the Euro Statutes].

29. *See id.* For example, the New York law states:

> (1) "Euro" shall mean the currency of participating member states of the European Union that adopt a single currency in accordance with the treaty on European Union.... (2) "Introduction of the Euro" shall mean and include the implementation from time to time of economic and monetary union in member states of the European Union in accordance with the treaty on European Union. ... 3) "ECU" or "European Currency Unit" shall mean the currency basket that is from time to time used as the unit of account of the European Community ....

N.Y. GEN. OBLIG. LAW § 5-1601.

30. *See* CAL. CIV. CODE § 1663(c); 815 ILL. COMP. STAT. 617/15 (West 1998); 1998 MICH. PUB. ACTS 394 § 1211(2); N.Y. GEN. OBLIG. LAW § 5-1601(2); 1998 PA. LAWS 122 § 3.

31. *See id.*

32. *See* James H. Freis, Jr., *Continuity of Contracts After the Introduction of the Euro: The*

achieve their primary purpose of ensuring that the continuity of contracts will not be affected.[33] According to the standard principles of statutory interpretation, any conflicts between the state legislation and the EU Council regulations must be resolved by selecting an interpretation of the state laws which conforms to the EU Council regulations.[34]

B. *Defects Inherent in the Status Quo: Anticipated Problems With Continuity of Contracts*

The legal instruments affected by the introduction of the euro may be exposed to a variety of risks. Specifically, a major area of concern in the United States is whether the continuity of contracts is subject to invalidation under frustration,[35] impracticability,[36] or other contract law theories.[37] While the adopted state legislation provides that mere introduction of the new European currency will not void contracts and other legal instruments, these laws have the same defect as the EU Council regulations: they do not reach beyond their jurisdictional boundaries.[38] The fact that several U.S. states opted to introduce legislation to ensure continuity of contracts suggests that other states are in need of legislation to alleviate threats to continuity of their legal instruments.[39]

United States Response to European and Monetary Union, 53 Bus. Law., May 1998, 701. The State Euro Statutes, *see supra* text accompanying note 28, resolve most of the discrepancies by mirroring the EU decisions. *See id.*; *see supra* text accompanying note 28. The statutes adopt by reference the official EU conversion rates for the national currencies replaced by the euro. *See id.* The acts also embrace the process of conversion adopted in the EU regulations. *See id.*

33. *See* Commission of the European Communities, *The Legal Implications of the European Monetary Union Under U.S. and New York Law*, Euro Papers, No. 15, Jan. 1998, at 9, *available in* <http://europa.eu.int/euro> [hereinafter Euro Paper No. 15].

34. *See id.*

35. *See* Marek, *supra* note 2, at 2026-27. Marek points out that in determining whether a contract should be terminated under the doctrine of frustration of purpose, courts will look at the issue of foreseeablity. *See id.* In cases where a contract was formed recently when introduction of the euro was a foreseeable event, the excuse will hardly be available. *See id.* In cases where a long term contract was formed during an era or "Europessimism" in the 1980s, contracts may be at risk of termination. *See id.*

36. *See id.* at 2015-18 (showing examples of how parties to transatlantic contracts may try to use the UCC to terminate a contract under the doctrine of impracticability).

37. *See* Meyers & Levie, *supra* note 13, at 345 (listing other theories such as force majeur, hardship, and other escape clauses).

38. *See* 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, 106 (1997) (arguing that "New York's legislative initiative raises serious doubts about the enforcement of obligations made in terms of the national currencies and governed by the law of a state which has not adopted a similar statute").

39. *See* JOHN REDWOOD, OUR CURRENCY, OUR COUNTRY: THE DANGERS OF EUROPEAN MONETARY UNION 139 (1997) (maintaining that the situation is open to law suits in states other than New York, where the parties will be able to argue that it took separate legislation to legalize the

IV. CHANGES PROPOSED BY OTHERS

A. *Lex Monetae: Will it Fill in the Gaps?*

It is likely that many non-E.U. countries not bound by EU Regulation 1103/97, including the United States,[40] will apply it under the principle of the State Theory of Money or "lex monetae."[41] Under the State Theory, money is money only when such character has been attributed to it by law.[42] In the United States, the UCC defines money as "a medium of exchange authorized or adopted by a domestic or foreign government and includes a monetary unit of account established by an intergovernmental organization or by agreement between two or more nations."[43] Hence, the UCC clearly stipulates that determination of what constitutes money is a governmental function.[44]

Further, the State Theory indicates that nominal value is attributed to the money by the law of the state with monopoly power over its currency because the state creates the unit of account as the reference of denomination.[45] It follows that the state law-making powers govern the conversion of the former currency into the new one during a currency alteration.[46] In this way, being a creature of law, the money is governed by the law of the currency (lex monetae) of the state exercising its sovereign powers.[47] Lex monetae universally applies when the new monetary system is introduced by the state.[48] Therefore, regardless of whether or not the contracts are governed by the law of that state, debts become expressed in the new currency.[49] Conforming to this principle, modern international law recognizes that each state exercising its sovereign powers has exclusive

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position in New York State itself).

40. *See* MANN, *supra* note 6, at 266-73 (arguing that lex monetae will apply regardless of the substantive law of the contract and that application of lex monetae represents the U.S. view). For discussion of the leading case regarding the application of the lex monetae, *Dougherty v. Equitable Life Assurance Soc'y*, 192 N.E. 897 (N.Y. 1934). *See* Gruson, *supra* note 38, at 79.

41. Euro Paper No. 15, *supra* note 33, at 9 (noting that the European Commission's contacts with non-EU participant governments demonstrated that the principle of lex monetae is in fact recognized in the main financial centers of the world).

42. *See* MANN, *supra* note 6, at 13. The State Theory of Money is inherent in the sovereign power or monopoly over the currency which the State assumes and which is confirmed in the constitution. *See id.* at 14.

43. U.C.C. § 1-201 (1998).

44. *See* MANN, *supra* note 6, at 13.

45. *See id.* at 51.

46. *See id.* at 50.

47. *See id.* at 267.

48. *See id.* at 262.

49. *See id.*

authority to determine what constitutes legal tender, and that the state's decision to change its currency will be binding on third parties.[50] Hence, under the State Theory of money, the Council Regulations may be applied by non-EU member countries, including the United States.[51]

However, U.S. courts have not always adhered to lex monetae,[52] particularly in cases where the contracts were denominated in collapsed currencies either because the currencies were not issued by legitimate governments or because the U.S. court was seeking to minimize damages that would result if the State Theory were to be strictly applied.[53] The three-year transitional period of the EMU raises concerns that have not arisen in previous changeovers to a new currency, where the old currency was withdrawn from circulation and legal instruments were redenominated immediately after the introduction of the new money.[54] Therefore, it remains unclear whether U.S. courts will follow a lex monetae approach or will instead rely on common law.[55]

B. *Inclusion of a Continuity Clause: An Alternative*

The parties to a contract may include in existing contracts a clause providing that the introduction of the euro on January 1, 1999 will not void the contract.[56] Some professional organizations such as the International Swaps and Derivatives Association ("ISDA") have produced a euro "Protocol" to modify its Master Agreements.[57] The protocol is a multilateral agreement including five model euro amendments that the parties could use to revise the existing Master Agreements, without

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50. *See* Petra Senkovi & Pierre Lastenouse, *The Influence of the Introduction of the Euro on International Arbitration*, 13 MEALEY'S INT'L ARB. REP., June 1998, at 3 (arguing that reference in contracts denominated in a currency of a Participating State will be interpreted with reference to lex monetae for contracts governed by the law of a non-European union jurisdiction which recognizes the State Theory of Money, namely Council Regulations 1103/03 and 974/98).

51. *See* Joseph Smallhover & Bernardine Adkins, *Euro Transition Period Poses Choices*, THE NAT'L L.J., July 1998, at B16 (arguing that under the principle of lex monetae, a court will apply the EU Regulations to determine the meaning of the currency in which an obligation is denominated or a court may alternatively apply the law of the place where the contract is to be performed when it is within the EU).

52. *See* Gruson, *supra* note 38, at 79.

53. *See* Euro Paper No. 15, *supra* note 33, at 5 (arguing that such cases have little or no relevance to the well thought out plan by one of the United States' closest allies for a smooth transition to the euro).

54. *See* James H. Freis, Jr., *supra* note 32, at 28.

55. *See id.*

56. *See* Lembergen & Wachenfeld, *supra* note 24, at 342 (arguing that in cases when continuity of contracts is at risk, specific continuity language may be necessary).

57. *See generally* ISDA Web Site (visited Feb. 25, 1999) <http://www.isda.org> [hereinafter ISDA Website].

renegotiating them individually.[58] The purpose of the protocol is to clarify their position on the continuity problem in jurisdictions other than those which have adopted "Euro Statutes" and to confirm the provisions of the EU and New York Law.[59]

Another euro "Protocol" was developed by the New York Financial Markets Lawyers Group ("FMLG") in collaboration with the British Bankers Association ("BBA") to enable parties to an International Foreign Exchange Master Agreement, International Currency Options Market Master Agreement, or Foreign Exchange and Options Master Agreement to amend that Master Agreement to confirm their intentions to be bound by the agreement.[60] The protocol is similar to the one developed by the ISDA: it includes several standardized clauses covering contract continuity, substitution of price sources, and definitions of the euro.[61] Both protocols are especially important to the swaps and derivatives contracts because contracts based on French francs or German deutsche marks, for example, may become meaningless when those currencies disappear,[62] or the parties who lost money might try to declare the contracts invalid.[63]

The adherence to either protocol by many financial actors shows that they realize the importance of solving the problem of continuity of contracts.[64] It is hardly possible, however, that each and every instrument could be amended with the help of the EMU protocols.[65] It is inevitable that litigation will arise in the absence of a broad national approach.[66]

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58. *See* Mark Goodman, *The Euro, Economics and Change – An Inquiry*, DERIVATIVES LITIG. REP., Nov. 1998, at 12.

59. *See* ISDA Website, *supra* note 57.

60. *See generally* Financial Markets Lawyers Group Web Site (visited Mar. 3, 1999) <http://www.ny.frb.org/fmlg/fmlgemu.html> [hereinafter FMLG Website].

61. *See id.*

62. *See id.* For a discussion of the legal aspects of the euro's impact on the securities market, *see* Aline van Duyn et al., *Legal Headaches, IT Traumas*, *in* EMU EXPLAINED, *supra* note 6, at 199-215. "For example, with a French franc/mark swap, a New York court could say that two legs of the swap become euro/euro and it does not look like a swap anymore, but an annuity. The purpose of the swap was to hedge or speculate and it no longer fulfils that purpose. The court may or may not say you need to terminate the contract, or rewrite it, because it no longer serves the original function." *Id.* at 203 (quoting Cliff Dammers, secretary general of the International Primary Market Association).

63. *See* Dominic Bencivenga, *Revisiting Derivatives; CFTC Proposal Sparks Regulatory Turf Battle*, N.Y. L.J., June 1998, at 8 (noting that the ISDA protocol allows successive amending of contracts).

64. *See* ISDA Website, *supra* note 57. In November 1998 ISDA reported the final list of 1,132 parties who adhered to the protocol. *See id.*; *see also* FMLG Website, *supra* note 60. In December, 1998 FMLG listed 224 parties who adhered to the EMU protocol. *See id.*

65. *See* Freis, *supra* note 32, at 37 (arguing that because EMU affects millions of contracting parties, a broader approach to resolving the continuity problem needs to be taken).

66. *See id.*

V. CONCLUSION

The European Union has come a long way preparing for the introduction of the euro. However, even the years of planning cannot foresee or cushion every aspect of the vast impact that the new currency will have not only in Europe but all over the world. While the legislation enacted in the European Union is an adequate measure for ensuring that the euro will not negatively affect the legal instruments within the Member States, these laws do not have legal effect outside of Europe.

Non-member States should devise their own provisions confirming that the obligations of the parties under existing contracts affected by the introduction of the euro will not be disturbed. In the United States, New York, California, Illinois, Michigan and Pennsylvania have enacted laws guaranteeing continuity of contracts. However, the rest of the states have yet to act to protect these contracts. While the law of these states governing these contracts may be the principle of lex monetae, this principle does not completely alleviate the potential enforceability problems. To lend a helping hand, the euro protocols have been suggested by ISDA and NYFMLG, but these measures lack the potential to address the issue of contract continuity on a global level. Yet in the absence of a uniform national solution to the problem of contract continuity outside the jurisdiction of domestic [the state] euro legislation, contract parties should take a case-by-case approach to their legal instruments, identify which contracts are involved and decide how the problem of continuity may be resolved.