Campos Ferreira
Sá Carneiro
& Associados

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EFFECTS OF THE EXIT OF PORTUGAL OUT OF THE EURO ZONE IN RELATION TO THE AGREEMENTS IN FORCE

There is a growing speculation on the political, economic, financial and legal implications of Portugal leaving the Euro Zone or of its full blown break-up. In this flash we propose to conduct a legal analysis of this issue, with a special emphasis on the effects of the adoption of a national currency in the agreements in force providing for payments in Euros.

Owing to the lack of legal framework for an exit/break-up, it is yet not possible to accurately anticipate the outcome of these events. The Portuguese civil legislation applicable to pecuniary obligations enshrines the so-called "principle of nominalism" , which is clearly inadequate for solving the problems arising in the various conceivable scenarios of an Euro-Zone break-up.

On another level of analysis, the way in which any dissolution process is conducted will also be of importance. Indeed, the consequences of an exit of a Member State multilaterally agreed, which involves the approval of ad hoc regulation on the various stages taking place in the exit process, will foreseeably be different from the opposite scenario – in our opinion less likely to occur – of a unilateral withdrawal by one or more Member States.

In light of the aforesaid, we will for now only make a high level analysis of some of the problems that could arise, either in a scenario of all Member States leaving the Euro, or upon the exit out of the Euro Zone by Portugal (eventually accompanied by a subset of countries). When possible, we will identify the measures that may already be implemented by the parties to agreements connected with Portugal, in order to prevent or solve some of the issues that could be posed.

1. It is being anticipated that the Member States leaving the Euro Zone would be compelled to enact legislation imposing redenomination into the national currencies, either on a domestic basis or through the conclusion of international conventions. In Portugal, these rules would foreseeably imply the mandatory and immediate conversion of any pecuniary obligations into the new national currency, at the rate fixed for such redenomination. In principle, every transaction executed between persons or entities resident in Portugal and/or involving the making of payments in Portugal would be subject to such new legislation. It would also not be surprising that, on a temporary basis, the government adopted other exchange control measures in order to limit the transfer of funds to other countries[i].

2. Hence, the contracts whose elements were connected with the Portuguese territory would fall within the scope of the said legislation, the parties being prevented to agree otherwise. Indeed, in accordance with an European Regulation in force[ii], when all other elements relevant to the contract at the time of choice are located in another country, other than the country whose law the parties have chosen to govern it, the mandatory provisions of the law of the first country shall apply[iii]. It is also likely that, similarly to what happened upon the introduction of the euro, the legislation enacted in Portugal would expressly reinforce the principle of the continuity of contracts, with the goal of preventing or reducing the risk of the parties attempting to unilaterally amend or rescind the contracts based on a material change of the circumstances upon which such parties based their decision to conclude such contracts.

3. In relation to the contracts connected not only with Portugal but also with other Member States, there are various scenarios to be considered:

    a. In a scenario where Portugal leaves the Euro Zone but this Union is not wound up, it is more likely that a court will conclude that the payments shall continue to be made in Euros, even though the agreements have some connection with Portugal and are governed by Portuguese law. This flows from the application of the internationally recognized *lex monetae* principle, according to which the "currency law" shall define the terms in which pecuniary obligations are converted into the new currency[iv]. Given that the EU Treaty and the Regulation establishing the Euro would be kept into force, the obligations in such currency should continue to be governed by that legislation, unless it is shown that the parties desired that the Portuguese law should apply nonetheless, due to a special connection of the agreement with Portugal.

    b. In a scenario of an Euro Zone full blown break-up, the consequences would be different:

        i. Given that the European legislation adopting the Euro would have been revoked and replaced with legislation requiring the mandatory redenomination into new national currencies, the main criteria for fixing the currency applicable to obligations connected with more than one Member State would be the law chosen by the parties to govern the agreement. Therefore, had the parties submitted the agreement to Portuguese law, the legislation approving the redenomination of the Euro into the new Portuguese currency should automatically apply. In this case, there would not be room for invoking the *lex monetae* principle, as the currency law – i.e. the Treaty of the European Union and the regulation approving the Euro – had ceased to exist, and thus one should assess the scope of application of two jurisdictions belonging to the already dissolved Union[v]. Naturally, insofar as the continuity of contracts is not imposed, and depending on the economic effects of such forced redenomination, a situation of this type – even not constituting a final and absolute impossibility to perform – could give rise to a modification or rescission of the agreements, based on a material change of circumstances upon which the parties have based their decision to conclude the agreements[vi].

ii. In relation to international obligations connected to both a Member State and a third country, the *lex monetae* principle could be applied, since there would exist a conflict between the jurisdiction which previously adopted the Euro and another one outside the Euro Zone. Hence, there would be some room to claim that the "currency law" was the one of the Euro Zone country mostly connected to the contract, thus the respective national currency succeeding the Euro at the legal rate of conversion approved, even in cases where the agreement is subject to the law of the third country[vii].

4. Nonetheless, there are certain factors which may cast some doubt on the conclusions reached above:

   a. Firstly, the place of performance of pecuniary obligations is an element of significant relevance. According to a provision set forth in an EU Regulation, regardless of the law chosen by the parties to govern the agreement, the mandatory rules of a country where the obligations are or must be performed shall always be applied, if, in accordance with those rules, the performance of the agreement is unlawful[viii]. Therefore, if the parties have agreed that payments under a foreign law contract shall be made through transfers to a Portuguese bank account, in a scenario of a Euro Zone break-up, a foreign law could not prevent the application of the Portuguese legislation converting the Euro into the new national currency.

   b. Secondly, there has been speculation about the possible application of Art. VIII(2)(b) of the IMF Convention, which enables the adherent States to adopt currency control rules to "exchange contracts", insofar as those rules are in accordance with that Convention. The English courts have been construing such rule in a restrictive way, arguing that its objective scope shall be limited to contracts implying a currency exchange[ix]. However, the Portuguese courts have not yet applied this rule, and one should not exclude that, in line with decisions previously adopted by other continental Europe courts, they sustain a broader interpretation of the said provision, in the sense of applying it to any agreement implying the transfer of currency to other countries.

   c. Thirdly, should the creditor fill a claim before Portuguese courts further to a default in payment of a pecuniary obligation, the upsides of subjecting the relevant agreement to a foreign law could be squandered. In an insolvency proceeding, any pecuniary claims accepted by the administrator shall be automatically converted into the Portuguese currency, in the context of the winding up or liquidation of the insolvency company[x]. As for enforcement proceedings, the payments in respect of obligations in a foreign currency may also be made in a Portuguese currency, at the exchange rate in force[xi]. Anyhow, this would be a deferred and contingent outcome subject to a failure to pay the pecuniary obligations.

5. In view of the aforesaid, and independently of the apparent unpredictability of the legal consequences arising from an Euro Zone break-up, there are by now measures that the parties to agreements connected with Portugal

may adopt when the obligations are also connected to another Member State, with a view to mitigate the risks arising from a rate conversion.

a. The choice of law applicable and the definition of the place of performance are particularly relevant, since these elements have a decisive role as criteria for determining the currency law, specially in a scenario of an Euro Zone break-up;

b. The parties may qualify the various break-up scenarios as events of default, thus allowing them to terminate the agreements, accelerate payment obligations or unilaterally amend the agreements;

c. The parties may attempt to include or refine the definition of "euros" in the agreements, in order to set the national currency applicable in case that currency ceases to exist in all or some of the Member States connected to the country – in some cases, this type of clause may be considered as valid by a court;

d. Nonetheless, it should be stressed that, being this matter appreciated by a court in Portugal, any clauses which shall contravene, at least directly, the application of the redenomination laws (e.g. denying such redenomination or foreseeing the mandatory conversion into another currency) may be deemed as null and void, due to a violation of mandatory law or, being the contract subject to a foreign law, be overruled by the Portuguese redenomination laws on the basis of public policy.

We again stress that the preceding remarks are still preliminary and may prove to be inaccurate, in particular if the Euro Zone break-up or the Euro exit by Portugal are accompanied by entering into multilateral conventions setting forth harmonized rules on the application of the various redenomination laws.

Indeed, the fact that there are problems which are difficult to solve without the enactment of the said legislation[xii], with the inherent negative impact on the economy, may lead the Member States to reach a multilateral agreement on that matter.

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[i] Vd. Eric Dor, "*Leaving the euro zone: a user's guide*", October 2011, publications of IESEG and Hal S. Scott, "When the Euro Falls Apart" in "International Finance 1:2, 1998, Blackwell Publishers Ltd.

[ii] Art. 3, nr. 3 of Regulation 593/2008, dated of 17 June on the law applicable to contractual obligations, available in this link.

For example, a loan granted by a Portuguese bank to a Portuguese company, where security is provided over assets located in Portugal but is subject to a foreign law.

The *lex monetae* principle flows from the State sovereignty principle, according to which each State shall have exclusive powers on matters related to the issuance of its currency. Thus, upon the adherence of each State to the EU, any pecuniary obligations subject to a non-EU jurisdiction whose payments should be made in the national currency of the adherent State has been automatically converted into Euro, due to the fact that the EU legislation – as the *lex monetae* – overrules the foreign legislation governing the agreement.

For instance, in a distribution agreement governed by the Portuguese law which is entered into between a Spanish exporter and a Portuguese importer, a Portuguese court would probably apply the act which introduces the new national currency in Portugal, and not the Spanish law, thus forcing the Portuguese importer to make payments in the Portuguese currency, in accordance with the conversion rate set forth in such act.

[vi] Article 437 of the Portuguese Civil Code.

[vii] For instance, in bonds issued by a Portuguese company in Euros, which are offered to English investors and subject to the English law, one should not exclude that an English court applies the Portuguese redenomination rules, by virtue of the "*lex monetae*" principle. In this scenario, the same Court would perhaps decide to apply the principle of commercial impossibility, in particular with the purpose of allowing the parties to terminate the agreement. Vd. on this matter "Currency Risk in a Eurozone Break-Up – Legal Aspects" in Nomura International Plc publications. In this case, the legal solution is not entirely predictable, since it varies depending on the foreign law applicable to the remaining clauses of the agreement.

[viii] Article 9, nr. 3 of Regulation 593/2008, of 17 June, on the law applicable to contractual obligations, available in this link.

[ix] Vd. Tennekoon, Ravi C, The Law and Regulation of International Finance, Tottel Publishing, 2009, page 34 and sq.

[x] In accordance with Article 96, nr. 3 of the Portuguese Insolvency and Recovery Code, the claims for the payment of money shall be considered as definitively converted into Euros, once recognized.

[xi] The Portuguese courts have recognized as possible that, within the context of an enforcement proceeding, the debt is paid in national currency at the conversion rate, in accordance with Article 558 of the Portuguese Civil Code (e.g. this decision, only available in Portuguese language). Nothing would prevent the Portuguese government from deciding that the obligations arising before the Euro break-up should be redenominated into the new local currency within an enforcement proceedings.

[xii] For instance, in a scenario of a break-up of the Euro Zone in its entirety, it may be impossible to determine the currency applicable to a joint venture agreement between companies located in Portugal, France and England, which foresees the yearly distribution of profit in Euros.