

E-ALERT | International Markets

December 16, 2011

THE EUROPEAN FINANCIAL CRISIS

Covington Creates Euro Crisis Interdisciplinary Response Team

SUMMARY

The crisis in the euro zone continues to create risks and uncertainties that will affect our clients' businesses in myriad ways. While it is not possible to predict the change in the euro zone that will result from the crisis, it is clear that change will occur. We have prepared this memorandum in order to assist clients in evaluating and responding to the legal, regulatory and policy ramifications of the next stage of the crisis.

This memorandum notes a range of potential risks and courses of action, including:

- Liquidity and financing alternatives
- Currency hedging
- Impacts on receivables and payables
- Counterparty credit risk
- Macroeconomic factors that could affect cash flows and asset valuations, even for businesses that are not directly exposed to the euro zone
- Key terms in existing material contracts to review to evaluate potential implications of the euro crisis, and potential changes to make in future contracts
- Pros and cons of amending existing contracts

Covington is pleased to announce that it has created an interdisciplinary and global team of attorneys and advisers to assist clients as they evaluate their response to the crisis. The "Euro Crisis" team consists of experts located in our Washington, D.C., New York, London and Brussels offices, and includes a former Ambassador to the European Union, a former Comptroller of the Currency, a former member of the European Parliament, a former Under Secretary of State for Economic Affairs in the U.S. State Department, as well as regulatory and corporate transactional lawyers with deep understandings of the global capital and credit markets.

The team also includes McLarty Associates, the well-known international consulting and strategic advisory firm with which Covington has a long-standing strategic alliance. McLarty counsels market participants in the United States and abroad on global strategic planning, government issues and advocacy, market access and political and economic risk issues. McLarty's staff includes former diplomats and trade negotiators, journalists, international business executives and cabinet ministers from key global markets. Together, Covington and McLarty can provide unparalleled real-time analysis and advice on the euro crisis.

INTRODUCTION

On December 8 and 9, EU leaders held another summit as they seek to contain and resolve the ongoing European financial crisis. Leaders of all the euro zone member states, plus six of the ten non-euro member states, agreed in principle to join a new pact designed to calm the markets and address the infirmities that have become evident in the structure of the common currency.¹ The pact includes an agreement to impose automatic sanctions on member states that violate EU fiscal guidelines, and to require that member states enact specified budgetary legislation. The summit also addressed additional contributions to the centralized bailout funds, touching on caps on such funds and potential requirements with respect to access to such funds.

The pact is an agreement to agree, and uncertainties remain as the final result emerges through a political process. The agreement is dependent upon legislative action by each country that agrees to participate in the pact (between 23 and 26 countries). In addition, certain countries may need to submit the pact to a national referendum, with the concomitant uncertainty that a national referendum necessarily entails. Market reaction following the announcement of the pact has been tepid at best.

The leaders' intent is that the pact will be finalized by early March. In the short term, the pact would appear to suggest two broad alternative outcomes. One is that the markets will perceive the pact as a step toward a broader resolution of the euro crisis, and will react accordingly. Stock prices, yields on sovereign debt and the value of the euro would stabilize. The member states would have some breathing room to continue to work on a longer-term solution to the crisis. The alternative is the opposite. Markets may not be calmed, possibly due to uncertainty regarding a final agreement itself, or uncertainty as to whether the ultimate agreement would sufficiently address the crisis. And continued uncertainty in the markets risks more extreme potential outcomes.

The euro crisis thus persists, with no conclusion clearly at hand. Regulators, market participants and the media are intently focused on the turbulence in the euro zone, along with the related negotiations regarding the sovereign debt of certain member states.² Speculation continues as to the future parameters of the euro currency.³

We have prepared this memorandum to assist clients in identifying and evaluating potential issues for their businesses that may result from the euro crisis. This memorandum is not intended to advise specifically on business strategies, including hedging or other mitigating strategies, as the strategy of each client will need to be individually devised through a thorough analysis of its assets, liabilities, cash flows and obligations. We do not predict either interim steps or the conclusion that may ultimately develop as a result of the ongoing efforts by leaders in the euro zone. Nor do we purport to predict the fate of the euro or the ultimate outcome of the euro crisis. With multiple outcomes possible, however, we believe that companies should continue to examine their businesses on an ongoing basis with all contingencies in mind. This memorandum is intended to provide a high-level framework to assist clients in identifying issues associated with the current turmoil in the euro zone, as well as to assist in formulating possible responses while these uncertainties persist.

¹ Three of the remaining four member states, Hungary, the Czech Republic, and Sweden, have indicated they may be willing to sign on, depending upon the definitive terms of the pact, leaving the UK as the sole, much-commented-upon definitive holdout. Other member states have subsequently raised questions about their ability and willingness to participate.

² As but one example, it has been reported that the UK Financial Services Authority is reviewing contingency plans at large British and international banks for the breakup of the euro zone.

³ We note that the US economy is also struggling, and these struggles contribute to the difficulties being encountered in the euro zone and globally. Our focus in this memorandum is on the euro zone, however, as it appears that those issues present greater potential risk for market participants in the near term.

Recognizing the import of these issues with respect to our clients' far-reaching business operations, Covington has formed an interdisciplinary and global team of attorneys and advisers to assist clients as they evaluate their response to the crisis. Our "Euro Crisis" team consists of experts located in our Washington, D.C., New York, London and Brussels offices, and includes a former Ambassador to the European Union, a former Comptroller of the Currency, a former member of the European Parliament, a former Under Secretary of State for Economic Affairs in the U.S. State Department, as well as regulatory and corporate transactional lawyers with deep understandings of the global capital and credit markets. We would be happy to introduce you to members of our Euro Crisis team to assist you in analyzing the legal, regulatory and policy implications of this ongoing crisis.

The team also includes McLarty Associates, the well-known international consulting and strategic advisory firm with which Covington has a long-standing strategic alliance. McLarty counsels market participants in the United States and abroad on global strategic planning, government issues and advocacy, market access and political and economic risk issues. McLarty's staff includes former diplomats and trade negotiators, journalists, international business executives and cabinet ministers from key global markets. Together, Covington and McLarty can provide unparalleled real-time analysis and advice on the euro crisis.

We first summarize potential outcomes of the Euro crisis in Part II below. This overview provides context for the discussion of potential implications for clients that follows in Part III of this memorandum.

POTENTIAL OUTCOMES IN EUROPE

We briefly identify below certain potential outcomes of the euro crisis that could come to pass. We do not attempt to predict—or rank—any specific outcome; instead, we simply list potential outcomes that have already been discussed in published analyses of the ongoing crisis.

1. Crisis resolves favorably

Efforts undertaken by the member states, the ECB and others cause the crisis to abate without any permanent disruption of the euro zone or of the EU itself. This could include a decision by the ECB to inject expansive liquidity into the European financial system—both by repurchasing sovereign debt in unlimited amounts to maintain an orderly market for those securities, and by injecting capital into euro zone banks to maintain the stability of the banking system. By printing money as necessary to maintain these steps, the ECB would likely be able to keep interest rates low (on a relative basis in the most vulnerable member states), but would risk stoking inflation across the euro zone.

This could also include the EU leadership successfully waiting out the crisis. The leaders' approach thus far clearly has been incremental, and there is speculation that this approach is in part informed by a desire to not utilize every potential tool at one time, lest that prove to be ineffectual and then the EU leadership finds it has no remaining options at its disposal.

2. Crisis does not resolve favorably

Despite efforts by EU leadership and member states, the crisis in the euro market could persist such that, by the end of March (or earlier if market participants conclude that the ultimate outcome is sufficiently certain that they should trade to protect themselves), there is not resolution or the previously implemented attempt to resolve these concerns has failed. Alternatively, it is possible that EU leaders' incremental approach to the crisis may be sufficient temporarily to calm markets,

but does not achieve the ultimate goal of resolving the euro crisis. Market patience would dictate whether the scenarios listed below—in particular, scenario A—would develop, and how severe such results would be.

A. The viability of the EU banking system is threatened

It is possible that the euro zone remains in its current form, but the banking system in some or all member states faces ever-increasing pressure. In such a situation, capital flight would increase, which would cause further financial distress within the euro zone, especially with respect to the most vulnerable economies. This could lead to more definitive action by EU leadership in an attempt to prevent a run on banks in one or more member states. The current discussions regarding the size and authority of a viable financing pool, such as the current European Financial Stability Facility (or the European Stability Mechanism, its proposed permanent replacement), or the creation of communal Eurobonds as a collective financing tool, could very well become more focused in this scenario.

B. Assisted exit by one or more member states from the euro zone

There is currently no mechanism for a member state to exit the euro zone without leaving the EU. However, in extreme circumstances, it is possible that a euro zone exit could occur either (1) through a mutual agreement between one or more exiting member states and the remaining member states or EU leadership (for example, as a condition to any negotiated restructuring or other resolution of a member state's sovereign debt) or (2) through an exit that is compelled by EU leadership or by the EU itself (for example, as a consequence of a default by the member state).

C. Unilateral withdrawal of one or more member states from the euro zone

The possibility exists that a member state will unilaterally withdraw from the euro zone, establishing its own currency in connection with such action. In contrast to the negotiated exits described above, this would likely be associated with an uncontrolled default by the exiting member state on its sovereign debt.⁴

D. Dissolution of the euro

In this “nuclear” scenario, the euro zone would be dissolved, and every former member state would create and maintain its own currency, presumably returning to a facsimile, at least in appearance, of pre-1999 Europe. Any bonds, commercial paper, derivatives or other contracts denominated in euro would become payable in the relevant replacement currency. Our expectation is that this would only occur as part of an uncontrolled collapse of the common currency, as opposed to a policy choice that the EU leadership would make when faced with other options.

In each of scenarios B, C and D above, any member state no longer using the euro as its currency would need to adopt and implement legislation creating its own currency. In countries with vulnerable economies, rapid devaluation of that currency would be expected, stressing the banking system, and that country would almost certainly need to implement currency controls to prevent bank runs and capital flight. It is difficult to predict the duration of any such controls. Even if a time limit is established at the time of imposition, it is entirely possible that the local government will elect to extend the duration of the controls if instability persists.

Inflation within the country also would be expected. Sovereign debt of that country, as well as certain private obligations with a nexus to that country, would likely become payable in the new,

⁴ In scenarios B and C above, it is possible that an exiting member state would also be expelled from the EU.

devalued, currency, affecting the banking system and other holders throughout Europe and globally.⁵ These pressures could, in turn, lead to a potentially severe recession across the euro zone as banks would likely further restrict their lending to reduce their balance sheets and thus ameliorate the deterioration in their capital position caused by the devaluation of sovereign debt they hold.⁶

POTENTIAL IMPLICATIONS FOR CLIENTS

While we cannot predict the ultimate outcome of the euro crisis, we believe that it is clear that change in economic policy in Europe in the near term is a given. The status quo is not sustainable, and if EU leadership does not design the change needed to address the issues in the European markets, the markets will force change in a less controlled and potentially more disruptive manner.

This change will clearly affect companies that are based in the EU, or that have significant operations in the EU. But we believe the effects will be felt globally, and could influence assets, liabilities and cash flows that have no direct connection with the EU. Markets are global to a far greater extent than was the case for any prior currency conflagration, so historical analysis of precedents and potential impacts may be of only limited relevance.

In this section, we identify a series of high-level considerations that market participants may find useful as an issue-spotting exercise. We hope this is helpful regardless of geographic location, but of course the relevance of some potential issues may vary depending on location or reach of operations. Some of these considerations, such as hedging, funding, asset protection and cash management strategies, are best addressed by market professionals. But legal considerations also abound, and we would be happy to assist in identifying risks and developing potential responses.

We divide our issue-spotting exercise into two categories: global, or macro, considerations, and company-specific, or micro, considerations.

Macro considerations

If events in the euro zone unfold into a full-blown crisis, certain consequences will reverberate on a macro basis globally. For example:

- China is a significant exporter to the euro zone. Economic distress in Europe could affect growth and profitability in China as exports decline and the value of the euro as compared with the yuan also declines. These factors could affect valuation strategies for investment in China. The value of the Chinese currency could also be affected if growth falls and the government elects to modify its current monetary policy. Japan could also suffer similar impairments. On the other hand, India is likely to be less affected as its trade volumes with the euro zone are not as significant.
- Several countries outside of the euro zone use the euro as a reference point for their currency management efforts. For example, Switzerland, although not a member of the EU, recently capped the value of the Swiss franc against the value of the euro. Denmark, an EU member but

⁵ In the case of a compelled departure of a member state, the question may be raised as to what the outcome would be if the departing member state refused to create its own currency and sought to continue to use the euro. Certain countries outside the EU use the euro as their official currency—for example, Monaco, Montenegro and the Vatican—both with and without official agreement with the EU. Additionally, certain countries peg their own currency to the euro.

⁶ We note that US banks in general hold smaller amounts of European sovereign debt than their European counterparts, so we would anticipate that this negative impact on the banking system would be more severe in Europe than in the United States. This would exacerbate the overall crisis in Europe, potentially severely, as European companies are more reliant on bank financing than are borrowers in the United States, where the capital markets provide a larger share of corporate funding.

not in the euro zone, closely pegs the Danish krone to the euro. Such a country may elect to shift this reference to a different currency (or currencies) deemed to be a safer haven, or to decouple its currency altogether. This could affect the relative value of that currency, affecting the country's economy as well as those with positions in, or relative to, the currency.

- The United Kingdom may be perceived as a safer haven than is currently the case, both because its government and central bank retain the ability to deflate its currency to enhance competitiveness, and also because the government's proposed response to the euro crisis has been viewed by the market as credible.
- However, recent developments regarding the EU's collective actions increase the possibility that the United Kingdom becomes somewhat more marginalized as compared to Germany, France and other larger economies within the euro zone. While this is unlikely to have a meaningful effect on the UK economy in the short term, it may affect the ability of the UK government to influence the direction of potential regulations in important sectors, such as the financial institutions that dominate the City of London. For example, a financial transaction, or "Tobin," tax, which has been proposed by the EU as a revenue-generation tool but vociferously resisted by the UK, may become a more likely possibility.
- The US dollar will likely become perceived to be a safer haven than the euro (the recent downgrade of the dollar notwithstanding). This could further increase the value of the dollar against the euro and, perhaps, other currencies as well, thus affecting price competitiveness of exports as well as the value of non-dollar cash flows to entities the functional currency of which is the dollar.

Micro considerations

In addition, there will be a wide range of direct potential consequences affecting entities with exposure to the euro zone, both for market participants that hold assets and liabilities denominated in euro, as well as for companies transacting in that region that depend upon cash flows in and out of the euro zone. We list certain consequences below to provide a framework for developing a response (we do not suggest that this is an exclusive list):

- **Business risks.** Are any aspects of a company's business particularly susceptible in the event of a serious disruption of the euro currency or in the EU generally, such as an increase in inflation, a decline in GDP, or a decline in the value of euro (or other) currencies held by the entity?
- **Difficulties in hedging exposure to the euro.** An obvious strategy is to enter into foreign exchange transactions designed to hedge exposure to the euro. However, it is already expensive to take short positions against the euro relative to historical levels, and those costs are likely to increase as difficulties in the region persist. Basic principles of supply and demand suggest that it will only become more difficult to effect this strategy, as by definition it requires a counterparty to take a position long the euro.
- **Disruption in payment patterns.** Payors in the euro zone that operate primarily in euro are likely to take longer to pay due to disruptions in general. Payors with functional currencies other than euro but with operations and cash flows in the euro zone will seek to pay obligations in euros rather than stronger currencies to take advantage of the lower cost of acquiring the currency—this may increase the pressure on non-euro zone suppliers to accept payment in euro as it declines in value. Payees in the euro zone with receivables denominated in safe-haven currencies are likely to push for accelerated payment in the non-euro currency, as that will likely

appreciate in value relative to the euro (and we expect there to be less receptivity to converting the non-euro payable into euro for purposes of payment).⁷

- ***Impact on location of free cash balances.*** Companies (whether inside or outside of the EU) will need to carefully consider where free cash balances are maintained. There is increasing concern that even large European banks may face liquidity issues in this crisis such that they may not be suitable counterparties for cash management or similar programs. This could apply equally to custodial arrangements for collateral posted and held in Europe. It is also possible that, if the situation deteriorates markedly in one or more countries in the euro zone, clearance and settlement systems could become clogged by surging volumes as market participants seek to reposition large holdings of cash or other assets, which could impair access to assets on a real-time basis.
- ***Further contraction of financing alternatives.*** Financing alternatives in the euro zone have become constricted during this financial crisis, and are likely to further contract. As noted above, bank financing is a far more important source of funding in Europe than in the United States. Banks are facing significant increases in core Tier 1 capital requirements, and recently announced updated stress tests in Europe make clear that these banks face significant capital shortfalls. Given the unattractiveness of raising equity in current markets, it is expected that a significant component of capital compliance will be the reduction of balance sheets, which entails a continued reduction in lending activities.⁸
- ***Shift in counterparty credit risk analyses.*** Counterparty credit risk analyses will likely be affected by geographic risk shifts in general, and there are likely to be potential shifts in specific counterparty risk metrics as well. These shifts would apply not only to customers, but also to banks, derivatives counterparties and other funding sources, and intermediaries such as clearance and settlement systems and custodians. Among the risks if one or more counterparties experience a material decline in credit rating include, to the extent it is a counterparty on a derivative transaction, that hedging transactions may cease to be an effective hedge to the company's risk given uncertainty as to performance by the counterparty. Collateralizing exposures may become more difficult, and, as noted above, companies will need to pay increased attention to where they hold collateral.
- ***Considerations regarding existing contracts.*** As a general matter, it may be unlikely that counterparties will be willing to amend existing contracts to clarify possible ambiguities arising from the euro crisis, as the difficult in predicting outcomes of the crisis would complicate efforts to enhance contractual certainty. However, companies with material contracts that could be affected by disruptions in the euro zone may find it prudent to analyze those contracts in advance of the onset of any disruption. In certain situations, counterparties may be open to mutually beneficial modification in light of this unpredictability.⁹ Considerations include:

⁷ We note that there is a significant shortage of US dollars in markets outside of the United States, particularly in Europe, notwithstanding the recent coordinated action by the Federal Reserve and other non-EU central banks to renew and significantly expand US dollar swap lines with the ECB, as well as to reduce the cost of accessing these lines. This will further incent payees to insist on payment of receivables from US companies in dollars rather than in euros.

⁸ While regulators in Europe seek to encourage financial institutions to issue contingent convertible securities as a form of core Tier 1 capital, widespread market acceptance of such a security has yet to develop.

⁹ We note that, in the context of derivatives documentation, the International Swaps and Derivatives Association has developed a means by which market participants can amend their existing ISDA documentation on an omnibus basis. Pursuant to an ISDA protocol, pre-determined and standardized changes to ISDA documentation will be posted on the ISDA website and market participants will be allowed to adhere to those amendments (with no changes to the proposed form) within a predetermined period of time. To the extent a counterparty also adheres, then all ISDA transactions between the two counterparties are deemed to be amended pursuant to the terms of the particular protocol. We anticipate that ISDA will consider developing a protocol should disruptions in the euro zone so warrant, but that would not occur until sufficient

- Assuming the contract is denominated in euro, is the currency defined? For example, a reference to the “euro” may produce a different result than a reference to “the lawful currency of [name of country]” if that country were to exit the euro zone.
 - Will any scenario trigger exit or termination rights, either for or against the company? For example, would a material adverse change, *force majeure* or frustration of contract clause (or comparable principle in the contract or common law of the jurisdiction governing the contract) be triggered? If so, are any such rights automatic, such that the contract can terminate without prior knowledge or action?
 - Are any notice provisions triggered, particularly if failure to provide required notice might trigger an event of default or otherwise adversely affect contractual rights.
 - In a financing or similar agreement, would provisions regarding repricing of interest rates or other payment obligations be triggered?
 - What is the governing law and place of payment under the contract? In many jurisdictions, principles of currency law (“*lex monatae*”) provide that the law of the home country of the contractual currency will govern as to the identity and composition of the contractual currency, rather than the law that otherwise governs the contract.¹⁰
 - If a company has the right to break contracts due to the euro crisis, does it face any reputational or similar risk in the market if it in fact exercises such a right?
- **Modification of contract forms.** While it may not be feasible to amend terms of existing contracts, companies could very well consider adjusting typical terms for new contracts going forward. This presumes, of course, sufficient clarity as to likely outcomes in Europe to enable the contracting parties to agree on how to structure their contractual affairs in advance of final resolution of the euro crisis. We believe that enhanced clarity as to the definition of contractual currencies, locations for payment and price source references, as well as termination provisions in the event of currency disruption, may be among the provisions meriting enhanced focus in this period of uncertainty.
 - **Technological changes.** In the event of an uncontrolled exit of one or more countries from the euro, consider logistical issues such as reprogramming of computer systems, effecting and verifying revisions to the company’s books and records to support subsequent auditor verification, recalibrating ATMs, vending machines and other equipment calibrated to a given currency, and, for companies that hold large amounts of currency in physical form, the logistics of converting from euros to the replacement currency.¹¹
 - **Disclosure considerations.** If the company is publicly held and has forecasted economic results to investors, do those disclosures need to be reconsidered? Are there any other disclosure considerations that may be relevant to the company?
 - **Safety considerations.** Consider potential security concerns for in-region employees and contractors should conditions deteriorate in a given location such that social unrest occurs.

time has passed to enable market participants to coalesce around a specific approach. The protocol approach does not preclude customized bilateral amendments between specific counterparties, and companies with material swap positions may find it in their interest to proceed on this basis rather than wait for an industry-wide solution.

¹⁰ This could, of course, present ambiguity in the context of the euro, in that the law governing the contractual currency could, to the extent that EU law was deemed to constitute *lex monatae* with respect to the euro, differ from the law governing the successor currency in the event a country withdraws from the euro and introduces a local currency.

¹¹ We note that historically it takes as long as six months for a country to print and mint sufficient quantities of bills and coins to replace an existing currency with a new currency, and the press has noted that there is limited capacity to print currency of sufficiently high quality in Europe.

- **Crisis management.** Further to the preceding bullet point (and also, as a general matter, further to the various topics noted above), evaluate the company's crisis management preparedness in light of potential developments in the EU and the potential impact of the euro crisis on the company. If not already in place, consider setting up an internal crisis management team focused on the euro crisis, and also evaluate whether outside advice might be warranted.¹²

Please reach out to any of the following attorneys or advisors at Covington or McLarty, or to your regular contacts at Covington, should you wish to discuss any aspect of this memorandum:

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¹² Covington has a dedicated Strategic Risk and Crisis Management team, dedicated to assisting clients respond to and address crisis events. The team consists of senior partners with extensive experience advising major corporations and other clients in high-profile crisis situations. We would be pleased to introduce you to this team to address crisis management preparedness matters relating to the euro crisis.