DechertOnPoint

March 2012 / Issue 7

A legal update from Dechert's Financial Services Group

The Eurozone Crisis: Risk Planning for Asset Managers

In recent months, the eurozone crisis has been continually in the news, including speculation as to whether one or more EU states may leave the eurozone.

In extreme form the crisis could result in some or all of the following "euro events" in respect of one or more of the weaker eurozone members (a potentially "exiting state"):

- a dramatic loss of confidence in the ability of the exiting state to maintain its financial creditability;
- transfer of funds away from financial institutions in the exiting state by domestic as well as foreign depositors
- fund transfers accelerate into a run on the banks;
- imposition of exchange and capital controls by the exiting state to prevent an exodus of capital;
- the exiting state leaves the eurozone (unilaterally or by some form of agreement) and redenominated its euros into a new domestic currency;
- this is followed by significant inflation and devaluation of the redenominated currency against the euro;
- affected banks and other institutions default by on their obligations, triggering creditors' claims and leading in some to insolvency or nationalisation;
- (conceivably) the imposition of border controls by the exiting state to prevent a temporary population shift out of the exiting state; and
- considerable uncertainty as to the correct legal characterisation of the above events in international and EU law, spilling over into uncertainty as to their impact on existing legal rights and obligations affected by these euro events.

The expectation is that these euro events will be focused in states most likely to leave the eurozone. But there could also be a spill over effect for other states and their institutions where they are exposed, or thought to be exposed, to the exiting state's default.

At this stage, we do not attempt to predict where or how any of these euro events may occur in the future. Rather, we set out a high level view of issues relevant to an asset manager, and which it will be prudent to plan for on a contingency basis, in the same way as for other major areas of identifiable risk.

Business Issues

Euro events could impact on an investment manager in a number of ways.

At the portfolio level:

- Do its investments have exposure to a potentially exiting state?
- Does it hold sovereign bonds issued by the state, or other securities whose issuers are based in that state?
- If so has it properly considered their position against its clients' risk profiles and investment objectives?
- If any changes are needed to reflect these issues, are such changes within the general scope of the manager's mandate or would they require client consent or other formal steps to be taken to give the manager the necessary flexibility?

Where a fund includes one or more euro share classes, is the identity of the "euro" sufficiently certain to survive a euro event? In most cases it is thought unlikely that an exit by one or even several states from the eurozone would alter the underlying nature of the euro, but for the euro share class this does ultimately depend on a legal construction of the terms of that particular class. Is a "euro" defined by reference to the eurozone's founding treaties, or as the currency for the time being of the fund's home state, or is it not defined at all?

Third Party Obligors

A range of issues arise where the manager or its funds deal with lending, investment or other obligations where the third party obligor is located in a potentially exiting state.

Cash Deposits

At the simplest level even a cash deposit is, in legal terms, a third party obligation owed by the bank to its depositor. Where cash forms part of the assets under management a manager may want to review how and where this cash is held, and by what institutions. A deposit of euros with a bank in London may be proportionately safer than a deposit in Greece because of risks of redenomination and the imposition of capital controls, not to mention defaults and insolvency moratoria.

Commitments

Similarly, where a lender or private equity investor has made a commitment denominated in euros, and the lender/investor is located in an exiting state, could its commitment be forcibly redenominated into a different currency? If so how challengeable is this, and how would the fund set about enforcing the obligation to pay in euros?

Contractual Rights on Default

Existing contracts may make the currency of payment clear. Others may be less specific, or be potentially overruled by a change in the national law of the obligor.

Most contracts do not currently address the possibility of a (purported) redenomination of the currency of payment. Such an event may not in itself amount to contractual frustration. Nor may it trigger a contractual event of default, though a "material adverse change" clause may be of help. Other provisions, such as currency indemnities may also provide support.

But in practice the first event grounding a cause of action may turn out to be a repudiatory breach indicating that the obligor does not intend to pay, an actual failure to pay, or the tendering of payment in the "wrong" currency amounting to substantive non-performance.

Enforcement

The manager's rights may depend not just on a construction of the contractual terms, but on fine issues involving the law of the exiting state, international private and public law and (insofar as it to the extent that it differs from international law) EU public law. Even if the euro exit is endorsed by the EU commission or other EU bodies, the legal ability of a state to exit from the eurozone is far from clear. Resolving these issues may depend on international judgments, as well as the jurisdiction in which a claimant seeks to enforce its claim.

Decisions will need to be made as to the value of pursuing a claim in the courts, and in which courts and jurisdiction to pursue such a claim. The availability of self help remedies such as set-off may become particularly important, as will the availability of any collateral.

Conclusion

At this stage it would be prudent to have an idea of what assets are exposed to what risks, the options available to minimise that risk, such as amending existing contract terms, reducing exposure to particular products or counterparties, and the course of action which the manager might be prepared to take if the unthinkable did actually happen.

Other *DechertOnPoints* will address these issues in more detail with reference to particular funds and situations. Please refer to our March 2012 *DechertOnPoint* "Risk Management by U.S. Mutual Funds Facing European Sovereign Debt Risk".

and our February 2012 *DechertOnPoint* "U.S. Money Market Funds and the European Sovereign Debt Crisis".

■ ■ ■

This update was authored by Richard Frase (+44 20 7184 7692; richard.frase@dechert.com).

Practice group contacts

For more information, please contact the author, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services.

Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

Peter D. Astleford
London
+44 20 7184 7860
peter.astleford@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Gus Black
London
+44 20 7184 7380
gus.black@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Alain Decombe
Paris
+33 1 57 57 82 82
alain.decombe@dechert.com

Graham Defries
London
+44 20 7184 7661
graham.defries@dechert.com

Eric Deltour
Brussels
+32 2 535 5418
eric.deltour@dechert.com

Joseph R. Fleming
Boston
+1 6178 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Richard Frase
London
+44 20 7184 7692
richard.frase@dechert.com

Richard D. Jones
Philadelphia
+1 212 698 3844
richard.jones@dechert.com

Matthew K. Kerfoot
New York
+1 212 641 5694
matthew.kerfoot@dechert.com

Stuart Martin
London
+44 20 7184 7542
stuart.martin@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Michelle Moran
Dublin
+353 1 436 8511
michelle.moran@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

Henry N. Nassau
Philadelphia
+1 215 994 2138
henry.nassau@dechert.com

Declan O'Sullivan
Dublin
+353 1 436 8510
declan.osullivan@dechert.com

Federico G. Pappalardo
Munich
+49 89 21 21 63 11
federico.pappalardo@dechert.com

Achim Pütz
Frankfurt
+49 69 7706194212
achim.puetz@dechert.com

Wayne Rapozo
London
+44 20 7184 7671
wayne.rapozo@dechert.com

Jonathan A. Schur
Paris
+33 1 57 57 80 53
jonathan.schur@dechert.com

Marc Seimetz
Luxembourg
+352 45 62 62 23
marc.seimetz@dechert.com

Hans Stamm
Munich
+49 89 21 21 63 42
hans.stamm@dechert.com

Thomas P. Vartanian
Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Holland M. West
New York
+1 212 698 3527
holland.west@dechert.com

Sign up to receive our other *DechertOnPoints*.

Dechert
LLP

www.dechert.com

Austin • Beijing • Boston • Brussels • Charlotte • Dublin • Frankfurt • Hartford • Hong Kong
London • Los Angeles • Luxembourg • Moscow • Munich • New York • Orange County • Paris
Philadelphia • Princeton • San Francisco • Silicon Valley • Washington, D.C.