

Financial Law — Panel —

ECONOMIC AND MONETARY UNION CONTINUITY OF CONTRACTS

**In the light of the European Commission's Proposal for a
Council Regulation on some provisions relating to the
introduction of the euro**

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The function of the Financial Law Panel is to identify areas of uncertainty in the law affecting financial markets, and to seek to remove them or limit their scope. This paper has been prepared to assist in this process. Its contents cannot be taken as legal advice in relation to a particular transaction or situation.

ECONOMIC AND MONETARY UNION CONTINUITY OF CONTRACTS

The story is told of the bishop who was asked to explain his views on the subject of sin. He said that he was against it. The judge who was asked for his thoughts on justice was equally clear. He was for it.

So it is with the legal principle of continuity of contracts. Everyone is in favour of it. There has been a great deal of discussion as to how this continuity should best be implemented and the form of legislation necessary to ensure it. But there has been little analysis of what the principle involves in the context of Economic and Monetary Union. The result is that consideration of the subject now centres on methods of achieving an objective which may on such analysis be found to be somewhat removed from the ideal which won universal approval comparatively recently.

The purpose of this memorandum is to draw attention to the nature of the question which is being addressed, and to invite consideration of whether the terms of the Commission's Proposal for the EU Council Regulation introducing the euro¹ may not in fact go as far as it is sensible to go at a Community level and whether issues relating to specific markets and individual Member States should be dealt with at a national level in accordance with the principle of subsidiarity.

The history of continuity of contracts

The Commission's Green Paper in May 1995 introduced the question of continuity to general debate. It appears as follows:

"Provisions exist in the national law of some Member States which allow one contractual party to terminate or modify the terms of a contract or an agreement

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Proposal for a Council Regulation on some provisions relating to the introduction of the euro.

without the consent of the other contractual party in case of a fundamental disruption in economic factors. Economic operators need to be certain that EMU will not constitute a fundamental disruption in economic factors such that contracts in national currencies and basket ECUs could be unilaterally revoked and would therefore need to be renegotiated. This "non-revocability" principle should apply in all cases."

It is important to note that the concern identified by the Commission is that EMU will lead to *economic* disruption. What the "economic operators" need (we are told) is to be sure that the *economic* process which surrounds EMU will not be such that it triggers the relevant legal doctrines in individual Member States. The paragraph does not suggest that those doctrines should be disappled: rather, it should be made clear that they will never need to be invoked. This is reinforced in the Green Paper a few paragraphs later:

"Neither the move to monetary union nor the introduction of the ECU (sic) constitutes a fundamental disruption in economic factors such that the millions of contracts in existence warrant renegotiation. Contractual parties will not have legal grounds for unilaterally terminating or modifying the terms of the contracts. However, contract law is embedded in the national legal systems, and the principles which determine the conditions under which contracts may be revocable are not identical across Member States. The Commission invites Member States to review national contract law provisions with a view to identifying any changes needed to guarantee the uniform application of the principle of non-revocability to the extent that it is related to EMU."

The Commission's view, in short, is that the process of EMU will not have any economically disruptive effect, and therefore all that is needed is to ensure that national legal rules do not intervene where no intervention is needed.

Early discussion proceeded in this context. The Member States, broadly speaking, agreed with the Commission that there would be no disruptive effect, and that their relevant national legal

provisions would not be invoked. Accordingly, their view was that nothing needed to be done.

Financial markets, however, looked beyond this. They could see the possibility in some specialised areas that the process of EMU might produce a significant shift in the economic consequences of existing contracts. Even though it was accepted that the triggering of relevant legal doctrines was unlikely even in the markets concerned there was a view, certainly within the UK and Germany, that legislative action was desirable in order to produce clarity and certainty. Much work has been carried out by the Commission, the EMI, and market participants to draft an appropriate form of Regulation. The Commission's Proposal deals with the point in Article 3 as follows:

"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 a legal instrument. This provision is subject to anything which parties may have agreed."

Article 3 takes broadly the same approach to continuity as was taken in earlier drafts of the Regulation. The Commission was urged, particularly by trade associations of banks, to amend earlier versions of the continuity provision. It was thought that the provision did not go far enough in enshrining the principle of continuity of contracts. A well-argued example of this is the paper of 16 September 1996 prepared by the Zentraler Kreditansschuss (a body representing the various German banking federations). This paper argued that the draft continuity provision:¹

"... does not adequately accommodate the request that continuity of contracts be ensured as fully as possible."

The paper went on to suggest that the first sentence of the continuity provision should begin with the words:

¹ The continuity provision which Zentraler Kreditansschuss were commenting on was set out in Article 5 of the 26th July 1996 draft of the Regulation.

"Neither the introduction of the euro as the currency of the participating Member States nor the replacement in legal instrument of references to the ECU by references to the euro nor any economic consequences that arise from any the aforementioned events or in connection with EMU ..." (emphasis added).

In other words, whatever economic consequences flow from EMU, the parties should be bound by their contract. The paper argued, however, that this should be subject to the terms of the contract. It cited in particular:

"... contracts often encountered in banking practice which provide for right of termination at any time even without any important reason."

The import of the paper, which is in line with other representations made to the Commission, is that contractual provisions should not be overridden, but that general provisions of national law, which might otherwise apply in the case of a disruption to the factual circumstances governed by the contract, should be abrogated in this case.

The two separate concepts

There are two quite separate concepts under discussion:

- 1 The idea set out in Article 3 of the Proposal. This requires that the change of the currency should not trigger a right given by national law (as opposed to a right given by the contract) to one or other of the parties to terminate or alter contracts. This concept does not address the position where the *economic or commercial effect* of EMU is the trigger for the legal right concerned.¹
- 2 The idea (referred to below as "the disapplication concept") that, whatever might be the economic or commercial consequences which flow from EMU, no provision of

¹ Earlier drafts made this point clearer, by providing that the introduction of the euro should not "*in itself*" trigger the legal consequences concerned. The deletion of those words have perhaps created an unfortunate ambiguity.

national law, which might operate to alter the rights and obligations of the parties, should apply. This principle should, however, be subject to any specific rights which parties might have by virtue of the contract itself.

The first of these two concepts is very close to the issue originally raised by the Commission in its Green Paper. The idea states what will almost inevitably be the case in fact, that the change of currency will not in itself trigger the legal provisions concerned, and so should not be able to be used by a contracting party as a technical excuse for it to avoid its contractual obligations.

The disapplication concept is not an extension of the idea set out in Article 3. It deals with something entirely different. Contrary to the assumption underlying Article 3 (ie that EMU will not in fact trigger rights under national laws), it accepts that EMU might in some circumstances produce an effect which national law would feel it appropriate to modify. It says, however, that the provisions of national law should, in the extraordinary circumstances of EMU, not apply.

Although the Commission has finalised its recommended wording, the form of the Regulation now falls to be considered by the Member States. The debate is not, therefore, finally closed. It is worth considering whether any change is necessary and in particular whether the disapplication concept should be entrenched at community level.

Difficulties in the way of the disapplication concept

The first of the two concepts set out above achieves the object originally raised by the Commission in a way that is, in our view, satisfactory. The disapplication concept, however, cannot effectively be included in the Regulation in the same way. There are a number of reasons for this:

- 1 It will be almost impossible to draft a Council Regulation which, uniformly across Member States, has the effect sought. The relevant provisions in national laws are not the same. Civil law countries, for example, may well have a provision of the

Civil Code which provides the court with a discretion to terminate a contract or to adjust contractual rights and obligations in the event of unforeseen onerousness¹. In England or Ireland, the courts could potentially apply a number of different approaches. There is, of course, the doctrine of frustration which has the effect of avoiding a contract altogether if the original object is effectively destroyed by unforeseen events. In addition a judge may sometimes invoke the concept of an implied contractual term to readjust a contract in the light of unforeseen circumstances².

The relevant national doctrines have been developed and statutory provisions have been enacted as tools to enable judges to do what is fair in a difficult (possibly disastrous) situation. If the disapplication concept is adopted in Community legislation, it will in practice amount to an instruction to national judges *not* to seek to do justice between parties. The Pavlovian reaction of judges, when faced with unfairness, is to remedy it. Any legislation which precludes this reaction will need to be drafted extremely tightly. An over-arching Regulation, which cannot deal with the detail of different national rules, is unlikely to be tight enough for this purpose.

2 However carefully it is drafted, a Regulation cannot deal with all of the possible difficulties in all Member States. It is inevitable that lacunae will remain and ambiguities of wording will be created, if the drafting attempts to go beyond the establishment of a broad principle. These ambiguities and problems of interpretation will fall ultimately to be resolved, in the event of litigation, by the European Court of Justice. This Court, for all its expertise, is not constituted specifically to deal with problems of financial markets and commercial contracts. A more certain course is to deal with matters, so far as possible, at national level so that any difficulties which do arise will be within the preserve of specialist national courts.

1 See, for example, the provisions of Article 1467 of the Italian Civil Code, under which a party may demand dissolution of certain kinds of contract, if unforeseen events have made performance excessively onerous.

2 See, for example, the opinion of Leonard Hoffman QC (as he then was) given to the Law Society in 1981 when Minimum Lending Rate (MLR) was abolished by the Bank of England. The opinion relates to the contracts which were then in existence, under which interest was to be calculated by reference to MLR.

3 It may be difficult for Member States to accept that they should risk imposing unfairness on their citizens, by abrogating the rules of law which are designed to alleviate it. In a working paper dated 19 September 1996 prepared by Directorate Generale XV of the Commission, dealing with the accounting consequences of EMU, there is a section which deals with "unfair outcomes of long term obligations". This sets out a series of hypothetical contractual situations, where the economic effect of EMU is to produce a result which is seen as unfair. The section concludes as follows:

"Unfair long term obligations could have a life threatening effect on some companies. Under certain circumstances it may be appropriate to revise contracts or to give support to companies affected by these problems."

If this is so, it will raise a number of further issues (eg the provision of State Aid to affected industries) which cannot be addressed now. What is clear is that Member States may well object to the terms of a Regulation which precludes national parliaments and courts from acting to ensure that fairness prevails and which may even entrench unfairness.

4 Although the disapplication concept deals with the position where a contract has become unfair or onerous as a result of EMU, it does not address the question where performance has become impossible. There may be cases (for example because of the disappearance of a particular index or reference source) where a contractual term is no longer capable of being performed at all. Laws in Member States somehow need to address this difficulty. It would not help for the Regulation simply to say that national provisions dealing with impossibility should not apply.

5 The adoption of the disapplication concept involves fixing the consequences of economic hardship wherever they fall. It is difficult to think that Member States would wish to pursue this course without a clear understanding of what that meant in

practical and political terms. The economic effects of EMU will vary between Member States. For example, it might be that domestic mortgages in a particular Member State are predominantly taken out long-term at fixed interest rates. After the advent of EMU it might be that long-term interest rates in that State fall very dramatically. The disapplication concept would hold that borrowers there would simply have to accept the consequence that they are paying in excess of the market rate. They could not invoke the relevant legal doctrine (assuming of course, that the effect were so dramatic that the doctrine would otherwise apply). This would be so, even if the bank lenders were able to reduce their costs of funding the loans (for example because the loans were financed from a short-term deposit base). Without having an idea of the economic outcome, it is hard to see how the government of the State in question could accept the disapplication concept as appropriate.

The preferred approach

It is to be hoped that all discussion of this topic is academic. The Green Paper started from the assumption that EMU would have no significant economically disruptive effect. That is likely in the vast majority of cases to be true. The process of EMU is a long one, beginning at the time when it was first aired as a serious proposal, and not ending until 2002. The economies of the Member States and the activities of the commercial communities in them will adjust to the change over that period. The point at which the euro is introduced will almost certainly have little economic significance in itself, since it will have been long anticipated.

Nonetheless, one must contemplate situations where economic difficulty is caused. It only becomes a suitable matter for legislative action, however, if:

- (i) circumstances exist where an established legal doctrine might be invoked; and
- (ii) the effect of the application of the doctrine is so widespread and uncertain that it endangers the stability of financial or commercial markets.

In this event, the decision as to the most appropriate course is a matter of public policy. It might be that disadvantaged commercial parties should be made to play the hand which EMU has dealt them. Alternatively, it might be felt better to relieve them in some way or another. These decisions, it seems to us, can only be taken in the light of circumstances and the prevailing national market. In other words, they can only be dealt with at a national level (although clearly the Community will be concerned to safeguard the integrity of the single market).

In our view the terms of the Commission Proposal are appropriate in dealing with the issues which should be handled at Community level. As far as other issues go, Member States may wish to follow the process which has been adopted by the FLP's project on continuity under English law. An investigation would be conducted to identify the economic problems that are possible in practice. Those situations would then be analysed carefully to see what the legal effect of them would be. Thereafter the national governments would be invited to make policy decisions in circumstances where those consequences are thought not to be desirable.

In our view the situation can only be addressed by locating the issues and dealing with them. Attempting to provide sweeping solutions to unspecified problems will not succeed.