STERLING MATTERS IN EUROLAND

LEGAL ISSUES SURROUNDING THE UK'S POSSIBLE ENTRY TO THE EURO WILL NEED TO BE IDENTIFIED WELL IN ADVANCE. **GEOFFREY YEOWART** OF LOVELLS SETS THE BALL ROLLING.

The legal framework for the changeover to the euro in the event of UK entry would need to be created as soon as possible after a UK referendum decision to join. Legal certainty would be essential to enable businesses to plan for the transition. As legislation would involve a significant lead time, the issues to be covered need to be identified well in advance and the approach to them agreed through consultation.

UK entry would require an EC Council Regulation that not only irrevocably fixed the conversion rate between the euro and sterling, but created a legal framework similar to that laid down in Regulation No 974/98 for the first wave of member states participating in the euro.

The UK would be in a different position as it would be joining after the end of the original transition period and after euro bank notes and coins had entered circulation in the eurozone. The new regulation would be based on the original one but suitably adapted to be specific to the UK and sterling. UK entry would also involve primary and secondary legislation at the UK national level to facilitate the changeover in several areas.

UK DEBT SECURITIES. The UK legislation would need to provide a procedure for redenominating sterling UK government securities to the euro, including timing and method of redenomination and rounding of nominal amounts after conversion. Gilts in registered form would be expected to be redenominated on entry by reference to individual holdings (by each stock account), and rounded to the nearest euro cent. Index-linked gilts would continue to be linked to the UK retail price index (RPI). Gilts in bearer form would be deemed to be redenominated on entry, but without requiring an actual exchange of paper instruments or physical "stamping over" of existing instruments. Private sector issuers of sterling debt securities governed by English law could usefully be given the right to redenominate those securities to euro voluntarily at any time during the UK transition period by a directors' resolution, without the need to convene a meeting of holders, unless the terms applicable to the securities expressly provided that redenomination would take place only at the end of the UK transition period. The method of redenomination and rounding would need to be specified and the treatment of debt securities convertible into shares would also need to be considered.

COMPANY SHARE CAPITAL. A company should be permitted the choice of either voluntarily redenominating its share capital from sterling to euro during the UK transition period or waiting until it ended. Changes to UK company law would be required to facilitate share capital redenomination. Although further consultation on the procedure for voluntary redenomination may be appropriate, the DTI proposed in September 1998 the following framework of statutory rules:

- Companies would be required to adopt a top-down method of conversion by converting at the level of the total nominal amount of each class of shares (rather than at the level of each individual share) and rounding that amount to the nearest euro cent. This minor rounding would not trigger any requirement for court or shareholder approval. Companies would derive individual par values by dividing converted share capital by the number of shares in the authorised share capital, leaving that figure stated to several decimal places if they so wished.
- A directors' resolution would suffice where the company was redenominating its shares into euro during the UK transition period, subject possibly to a shareholders' power of veto.
- Companies would be permitted to adjust the resulting par value of each share to a more convenient round figure in euro, subject to shareholder approval, but without the need for court approval. There would be no requirement for companies to issue new share certificates following redenomination. Any change in the total nominal share capital would be combined with a corresponding adjustment to the company's reserves.
- Companies would be permitted to resolve that references in any document to share capital denominated in sterling would be read as a reference to the equivalent amount in euro.

If a company decided to renominalise (as well as redenominate) its shares, it would have the choice of rounding up the nominal amount of each share to a convenient round figure in euro by capitalising reserves or (if it had insufficient reserves) of rounding down (probably to the nearest euro cent) as illustrated by *Table 1*.

It is expected that a public company could renominalise its shares only by a shareholders' resolution, in view of the requirements in the Second EC Company Law Directive governing the increase or reduction of share capital. Public companies would have to plan ahead so that suitable shareholders' resolutions could be tabled at annual general meetings, without incurring the costs of convening extraordinary general meetings. The redenomination of share capital to euro would be permissible, but not compulsory, during the transition period. The UK legislation should clarify what would happen at the end of the transition period to sterling share capital which had not been formally redenominated to euro in advance.

Automatic (mandatory) conversion of sterling share capital to euro at the fixed conversion rate, using the top-down method, appears most appropriate. The legislation would need to clarify whether the nominal value of each share so converted would be left stated to several decimal places or rounded to the nearest euro cent. Rounding could give rise to significant rounding differences in the case of shares with small nominal amounts (such as 1p, 5p or 10p) and it might be best if rounding of nominal values was made possible, but not compulsory. If this approach was adopted, companies could still choose, after conversion, to renominalise their shares by a shareholders' resolution if the above legislation had been adopted.

TABLE 1

ROUND FIGURES

Example of one possible method for redenominating shares:

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- Authorised share capital: £100,000 (100,000 shares of £1 each)
- Issued share capital: £75,000 (75,000 shares of £1 each)
- Assume a (hypothetical) conversion rate of €1 = £0.641234
- Authorised share capital £100,000 converted to euro @ 0.641234 = €155,949.31
- Nominal value of each £1 share = €1.5594931
- If reserves are available, renominalise the par value of each share upwards to €1.60 and capitalise €3,038.02 to pay the difference (€0.0405069 per share) on the issued shares
- If no reserves are available, round down the nominal value of each share to the nearest euro cent, so reducing it by €0.0094931; then multiply this amount (€0.0094931) by the number of shares in issue (75,000) to give €711.98 which amount is transferred to a special undistributable reserve. A similar transfer will be necessary if any of the 25,000 unissued shares are subsequently issued.

If the shares are renominalised upwards to €1.60 each by capitalising reserves, the authorised share capital would be €160,000, the issued share capital would be €120,000 and reserves would be reduced by €3,038.02.

Alternatively, if the nominal amount of each share is rounded downwards to the nearest euro cent, the authorised share capital would be €155,000, the issued share capital would be €116,250 and reserves would be increased by €711.98.

NO PAR VALUE SHARES. Another way of avoiding the problems otherwise arising on redenomination would be for the UK legislation to allow true no par value (NPV) shares. Instead of individual shares having a fixed nominal value, each NPV share would represent a proportion of a company's total share capital. The number of shares in issue could remain the same. There would be no par value to redenominate, no resulting decimal figures to round or renominalise, and changes to registers and certificates would be minimal. It would also avoid the need to cash out any awkward fractional interest that might arise when shares are redenominated and renominalised. An NPV share would not have any monetary relationship to a company's share capital and would simply represent a fractional share in the company's total net worth. There is considerable support in the UK for the 'true' type of NPV share. However, in the case of public companies, this type of share, which is commonly used in the US, would not appear to be compatible with the Second Company Law Directive in its present form. The European Commission set up a Group of High Level Company Law Experts in September 2001 to consider the modernisation of company law in Europe. The Group has invited comments on a range of issues, including the possible introduction of no par value shares. Go to www.europa.eu.int/comm/internal_market/en/company/company/modern/index.htm for more information. The Group is expected to report on its conclusions to the Commission by the end of this year. Until its conclusions are made public, though, it is not possible to tell whether there is a prospect of true NPV shares being introduced and, if so, when this is likely to occur.

DIVIDENDS, COMPANY ACCOUNTS, HISTORICAL DATA. The UK legislation should clarify that dividends could be paid in either sterling or euro during the transition period and that, where euro dividend payments were made on shares denominated or formerly denominated in sterling, the rounding rule could apply to the total dividend payable on a shareholding and not to the individual dividend par share (the latter approach could lead to significant rounding differences).

It should be made clear that financial statements relating to periods ending on or before the last day of the UK transition period could be stated in either sterling or euro, even if they were not filed at Companies House until after the end of the transition period. Similarly, it should continue to be possible for internal data and records relating to transactions entered into before the end of the transition period to be maintained in sterling after that date. Where information relating to transactions entered into after the end of the transaction period was to be reported externally (including on screens and in customer statements), it should be expressed in euro.

CONTRACT CONTINUITY AND PRICE SOURCES. Another question is whether the UK legislation would need specifically to confirm continuity of contract. The introduction of the euro on 1 January 1999 did not have the effect of altering any term of a contract, or discharging or excusing performance, or entitling a party unilaterally to alter or terminate the contract: Council Regulation (EC) No 1103/97. Although not legally binding, the recitals of this regulation state that the principle of contract continuity implies that the introduction of the euro did not alter the nominal interest rate payable by the debtor under a fixed rate instrument.

This continuity principle is expressed to be subject to anything which the parties may have agreed, so preserving freedom of contract. Outside the EU international law broadly requires states to recognise the currency of other states, but there may be areas of uncertainty. Legislation was enacted in several jurisdictions, including the States of New York, Illinois, California, Michigan and Pennsylvania, Hong Kong and Singapore, specifically to clarify the position.

Contracts might be affected by the disappearance of a benchmark, index or pricing source linked to sterling. Several first wave member states, including Germany and France, introduced domestic legislation to designate successor price sources. A contract governed by English law which failed to identify a replacement price source might be unenforceable for uncertainty. The English courts could be expected to lean towards implying a term that the nearest comparable successor rate (if readily ascertainable) should be adopted in the absence of a contrary intention of the parties. This might not be easy to do in all cases, but trade associations did much useful work when the euro was first launched in identifying affected benchmark rates and ensuring that designated replacement rates were provided. They could be expected to do the same in the event of UK entry.

TAX LEGISLATION. The UK legislation would need to include a general power (similar to that conferred on the Treasury by section 163 of the Finance Act 1998) to make regulations to ensure that, as far as possible, the changeover to the euro was tax-neutral. The regulations would need to deal with issues similar to those dealt with in the European Single Currency (Taxes) Regulations 1998. This allowed the deduction for tax purposes of the costs of redenominating shares and securities in euro, provided for the tax treatment of various financial transactions affected by the euro and also made consequential changes to legislation on such matters as controlled foreign companies and local currency elections.

CONSEQUENTIAL CHANGES. A general power would need to be included to make necessary consequential changes to other UK legislation (which would need to be identified by a separate review), including the rounding of monetary amounts to convenient euro amounts and any appropriate changes to legislation relating to cheques, bills of exchange and promissory notes.

PLANNING AHEAD. The November edition of the Bank of England publication *Practical Issues arising from the euro* will contain an expanded and updated version of the City Guide to a UK Euro Changeover (including guidelines to help UK companies). Visit the Bank's website at www.bankofengland.co.uk for more information. Companies are invited to comment on what legislation they consider would be required to assist them in the changeover to the euro by sending their views to the ACT via **technical@treasurers.co.uk.**

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