

June 10, 1998

MEMORANDUM TO: Financial Markets Lawyers Group

RE: Interpretation of New York's Recently Enacted Continuity
of Contract Statute

Introduction

On July 29, 1997, New York enacted the Continuity of Contract statute, 1997 N.Y. Laws, Ch. 311, which is codified at Sections 5-1601 *et seq.* of the General Obligations Law. The Continuity of Contract statute (which we refer to in this memorandum as the "Continuity Law" or simply as the "statute") was prompted by the expected introduction in January 1999 of the euro, which will replace the currency of those countries of the European Union that adopt it as their single currency. The Continuity Law addresses the legal effect of the introduction of the euro on contracts, securities and other instruments that are governed by New York law and that designate as the subject matter or medium of payment a currency that has been substituted or replaced by the euro. The statute seeks to answer the question: What rights and obligations do parties have under New York contracts involving a currency that is being replaced by the euro?

Since its enactment, some lawyers have expressed differing views as to whether the Continuity Law applies only to contracts^{1/} entered into after its enactment or whether it applies to existing contracts as well. We have been asked to express our views on how we believe a New York court would analyze the issue under the governing standards of statutory construction.

As described more fully below, we believe it highly likely that a properly informed New York court would interpret the Continuity Law to apply to all contracts, whether entered into before or after the statute's effective date. That interpretation is compelled, in our view, by the plain language of the Continuity Law and is further supported both by its legislative history and by its intended objectives. We also believe that, when properly construed, the Continuity Law does not unlawfully impair existing contract rights in violation of the Constitution of the United States or the Constitution of the State of New York.

I. THE CONTINUITY LAW APPLIES TO EXISTING CONTRACTS.

The critical starting point in the process of statutory interpretation is the language of the statute itself. As the New York Court of Appeals, New York's highest court, stated not long ago:

Where the statute is clear and unambiguous on its face, the legislation must be interpreted as it exists. . . . It is fundamental that a court, in interpreting a statute, should attempt to effectuate the intent of the Legislature, and where the statutory language is clear and unambiguous, the

^{1/} For convenience, we use the term "contracts" to include also "securities" and "instruments," which are covered by the statute.

court should construe it so as to give effect to the plain meaning of the words used.

Doctors Council v. NYC Employees' Retirement System, 71 N.Y.2d 669, 674-75, 529 N.Y.S.2d 732, 735 (1988), (citations and internal quotations omitted); *see also* 1 MCKINNEY'S STATUTES § 94 at 188 (1971) ("The legislative intent is to be ascertained from the words and language used. . . .").

Section 5-1604 of the Continuity Law is captioned "Application."

Section 5-1604(1) states in part:

[T]his title shall apply to *all* contracts, securities and instruments, including contracts with respect to commercial transactions, and shall not be deemed to be displaced by any other law of this state. (Emphasis added.)

Applying the fundamental canon of statutory construction stated above, a court almost certainly would conclude that the phrase "all contracts" means just what it says. It does not mean "all contracts entered into after the effective date of this statute." To limit the universe of covered contracts in that manner would convert the word "all" to mean "less than all." Since the phrase "all contracts" plainly means "every contract," a court would be required to interpret the Continuity Law to apply to every contract, regardless of when that contract was entered into.

The legislative history of the Continuity Law, albeit sparse, also supports the application of this statute to existing contracts. The supporting memoranda submitted by the bill's sponsors (Assemblywoman Helene Weinstein and Senator James Lack) both made specific reference to the possible effect of the introduction of the euro on "existing contracts," stating:

On January 1, 1999, the euro will become the currency of the participating member states of the European Union. This will create uncertainty in relation to *existing contracts* in other designated currencies. . . . This bill clarifies that such contracts will still be fully enforceable, since “euros” may be substituted, at the appropriate exchange rate, for the original currency referred to. (Emphasis added.)

As this legislative history demonstrates, the Continuity Law was enacted to deal with the “uncertainty in relation to existing contracts” caused by the introduction of the euro. The contracts possessing the greatest uncertainty were those that existed before the statute was enacted. Indeed, the title of the statute, “Continuity of Contract,” suggests that those contracts were a principal concern of the statute. An interpretation of the Continuity Law that limited its application only to future contracts would have the perverse effect of leaving unprotected those contracts in greatest need of the statute’s benefits. Not only would this do violence to the plain meaning of the statute’s reference to “all contracts,” it would also frustrate a prime objective of the statute.

Our conclusion that a court would interpret the Continuity Law to apply to existing contracts is not altered by the general presumption that statutes operate prospectively only. *See generally*, 1 MCKINNEY’S STATUTES § 51 and cases cited. That presumption is not absolute. As the Court of Appeals has stated in language equally apt here:

It takes a clear expression of legislative purpose . . . to justify a retroactive application but that purpose is here unequivocally established not only by the literal language of the statute . . . not only by its context but by its legislative history as well.

Gleason v. Gleason, 26 N.Y.2d. 28, 36, 308 N.Y.S. 2d 347, 352, (1970) (Fuld, C.J.; citations and internal quotation omitted). In addition, the Continuity Law may fairly be viewed as a “remedial statute” designed to clarify an uncertain state of the law. Such statutes are generally regarded as having retrospective application. *See, e.g.*, 1 MCKINNEY’S STATUTES § 54 at 108-09 (Remedial statutes include “those designed to correct imperfections in the prior law[.]” As such, they “constitute an exception to the general rule that statutes are not to be given a retroactive operation, since they are to be liberally construed to spread their beneficial results as widely as possible” (citations omitted)).

II. PROPERLY CONSTRUED, THE CONTINUITY LAW DOES NOT UNLAWFULLY IMPAIR EXISTING CONTRACT RIGHTS.

Even though New York may enact legislation that applies to existing contracts, such legislation is subject to limitations imposed by the federal and state constitutions. The Contract Clause of the U.S. Constitution (Article I, § 10) prohibits states from passing laws impairing the obligation of contracts. While the New York State Constitution has no counterpart Contract Clause, the due process clause (Article 1, § 6) of the state constitution has been construed to impose a similar limit on legislative action.

A brief discussion of several basic propositions derived from U.S. Supreme Court decisions is useful to an analysis of the Contract Clause implications of the Continuity Law. Much of the Contract Clause case law, particularly from the 19th century, reflect the Lockean notion of “vested rights.” Those cases hold that contracts implicitly incorporate the relevant legal rules existing at the time of formation and thereby

create “vested rights” that may not be altered or impaired by subsequent state legislation. *See, e.g., Von Hoffman v. City of Quincy*, 71 U.S. (4 Wall.) 535 (1867). The Contract Clause protects the parties’ reasonable expectations that are derived from the existing rules of law pertaining to the validity, construction and enforcement of contracts. Although later Supreme Court cases have interpreted the Commerce Clause quite differently, this notion still retains vitality in current Contract Clause case law. *See General Motors Corp. v. Romein*, 503 U.S. 181, 189 (1992) (“For the most part, state laws are implied into private contracts regardless of the assent of the parties only when those laws affect the validity, construction and enforcement of contracts”).

Since at least the 1930s, the U.S. Supreme Court has retreated from an absolutist view of the Contract Clause. In its seminal decision in *Home Building & Loan Ass’n. v. Blaisdell*, 290 U.S. 398, 437 (1934), the Court declared that, although the language of the Commerce Clause is facially absolute, “the economic interests of the State may justify the exercise of its continuing and dominant protective power notwithstanding interference with contracts.”

Under current Supreme Court jurisprudence, the analysis of Contract Clause issues involves a balancing of interests: On the one hand, the interests of parties to contracts in the protecting their reasonable expectations; and on the other hand, the interest of the state in exercising its police power to advance a legitimate public purpose. *See, e.g., Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411-12 (1983). The threshold inquiry is “whether the state law has, in fact, operated as a substantial impairment of a contractual relationship.” *Allied Structural Steel Co. v.*

Spannaus, 438 U.S. 234, 244 (1978). If the state law alters contractual obligations only minimally or not at all — such as by clarifying existing law or extending it in a manner consistent with existing law — there is no impairment of contract rights and the inquiry is at an end. *Allied Structural Steel Co.*, 438 U.S. at 245. If, however, the state law “constitutes a substantial impairment, the State, in justification, must have a significant and legitimate purpose behind the [statute], such as the remedying of a broad and general social or economic problem.” *Energy Reserves Group*, 459 U.S. at 411-12 (citations and internal quotations omitted).

Before analyzing the substantive provisions of the Continuity Law in light of the foregoing guidelines, it is important to keep in mind that the statute expressly permits the parties to make their own agreements regarding the introduction of the euro, the terms of which agreements will prevail over the provisions of the statute. *See* Section 5-1603 (“The provisions of this title shall not alter or impair and shall be subject to any agreements between the parties with specific reference to or agreement regarding the introduction of the euro”). Thus, in effect, the statute supplies default provisions that apply only when the parties’ contract does not specifically deal with the introduction of the euro. In those situations, the Continuity Law contains three substantive provisions that we have analyzed to determine whether any of them substantially alters existing contract rights and, if so, whether such alteration is justified by some legitimate state interest.

The first substantive provision of the statute is found in subdivisions (a) and (b) of Section 5-1602(1), which declare that “the euro will be a commercially

reasonable substitute and substantial equivalent” (i) for those currencies that are substituted or replaced by the euro (subdivision (a)) and (ii) for the ECU (subdivision (b)). The concepts of a “commercially reasonable substitute” and “substantial equivalence” are not new to New York law. Similar concepts are found in New York’s Uniform Commercial Code, first adopted in 1964. For example, Section 2-614(2) of the UCC, which deals with substitute performance in connection with the sale of goods, states in pertinent part:

If the agreed means or manner of payment fails because of domestic or foreign governmental regulation, the seller may withhold or stop delivery unless the buyer provides a means or manner of payment which is *commercially a substantial equivalent*. (Emphasis added.)

In our view, subdivisions (a) and (b) of Section 5-1602(1) simply apply the established concept of substitute performance in a new context occasioned by the introduction of the euro. As such, these subdivisions of the statute provide contract parties with a measure of certainty about the performance of their obligations that they would otherwise lack. Moreover, the rule set forth in these provisions is most likely the rule courts would adopt in the absence of such legislation. For these reasons, we do not believe the validity of subdivisions (a) and (b) of Section 5-1602(1) could be successfully challenged as altering existing contract rights.

For similar reasons, we do not believe the second substantive provision of the Continuity Law, set forth in Section 5-1602(2), raises serious questions as to validity. Section 5-1602(2) states that the introduction of the euro (and related matters) shall not have the effect of discharging or excusing performance under any contract or give a party

the right to unilaterally alter or terminate any contract. The rules set forth in this subsection follow from the concept of substitute performance stated in subdivisions (a) and (b) of Section 5-1602(1) and are consistent with the doctrine of “substantial performance” that has been long recognized in New York. Judge Cardozo gave voice to the doctrine of “substantial performance” in the famous case of *Jacobs & Young, Inc. v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921). In that case, a construction contract contained an express stipulation requiring that a particular brand of steam pipe be installed; the builder mistakenly installed a different brand of pipe of equivalent quality, and the owner refused to pay on account of the builder’s failure to comply fully with the terms of the contract. Speaking for a majority of the Court of Appeals, Judge Cardozo held that the builder’s substantial performance of the terms of the contract required the owner to honor in full his contractual obligations. The owner’s remedy was a claim for damages, if any, based on the provable difference in value between the house as constructed and the house as specified in the contract. Since *Jacobs & Young*, the doctrine of “substantial performance” has become firmly rooted in the contract law of New York and elsewhere. *See generally*, 3A CORBIN ON CONTRACTS §§ 700 *et seq.* (1960) and cases cited. Section 5-1602(c) is an unexceptional application of that doctrine to contracts involving currencies replaced by the euro.

We have deferred until now consideration of the remaining substantive provision of the Continuity Law, which is contained in Section 5-1602(1)(c), because it is the only provision that, in our view, could require judicial interpretation to avoid impairment of existing contracts. The feature of that subsection that gives us pause is the

opening clause, which states that performance of the obligations described in subdivisions (a) and (b) of Section 5-1602(1) may be made *either* in the currency or currencies originally designated in the contract (if still legal tender) *or* in euro. This clause appears to give recognition to the fact that, during a three-year transitional period following the introduction of the euro, the currency of participating countries will still be legal tender, albeit as denominations of the euro at fixed conversion rates. In addition, during that transitional phase to a single European currency, the euro itself will exist only as a currency unit of account as it will not be issued in physical banknote or coin form until the end of that period. Thus, during that transitional period, the euro itself may be used only to settle “cashless” transactions. The seeming effect of Section 5-1602(1)(c) is to give a party an *option* as to the currency unit it may use in such transactions: either perform in the currency designated in the contract or perform in euros.

We are unable to identify any significant interest New York could have in affording contract parties such an option. We are also unable to discern from the language of the statute or from its limited legislative history whether performance in euros is intended to constitute “full performance” or merely “substantial performance” of obligations designated in a currency that has been replaced by the euro.

Unless performance in euros is truly equal in all material respects to performance in the designated currency, potentially serious issues could arise if Section 5-1602(1)(c) were construed to mean that performance in euros discharged all obligations to perform in the original currency designated in the contract. For example, there could be conversion costs, arbitrage opportunities, liquidity preferences or other factors that could

make a party's performance in euros more costly or of less value to the other party than performance in the designated currency. In such situations, we see no apparent reason for treating performance in euros to be the same as performance in the currency designated in the contract, nor do we see that New York could have any economic interest in requiring such treatment. Absent some legitimate state interest, a New York statute that forced a party to accept euros in lieu of the contractually agreed currency (when that currency is still legal tender) could well be declared an unconstitutional impairment of contract. *See, e.g., National City Bank of New York v. Gelfert*, 284 N.Y. 13, 29 N.E.2d 449 (1940) (state statute improperly impaired existing contract rights of mortgagees by changing the medium of payment of mortgage debts; practical effect of statute was to require mortgagees to accept the mortgaged property as payment of outstanding debt instead of payment in lawful U.S. currency).

New York courts follow the time-honored rule that statutes should be construed in a manner that avoids constitutional infirmities. *See, e.g., Bennett v. County of Nassau*, 47 N.Y.2d 535, 540, 419 N.Y.S.2d 451, 453 (1979); 1 MCKINNEY'S STATUTES § 150(c) at 321 and cases cited. Applying that rule to Section 5-1602(1)(c), a court could quite easily construe the performance "option" of that subsection to mean nothing more than that a party's election to perform in euros constitutes "substantial performance" of its obligation to perform in the contractually designated currency. Such a construction would be consistent with the other substantive provisions of the Continuity Law. It accords with the concept of "substantial equivalence" between euros and the original currencies, as set forth in subdivisions (a) and (b) of Section 5-1602(1), and with

the concept of “substantial performance” as reflected in Section 5-1602(2). Most importantly, such a construction protects the reasonable expectations of parties to existing contracts that involve currencies replaced by the euro. In those instances in which a party elected under Section 5-1602(1)(c) to perform its obligations by using euros rather than the contractually designated currency, that party would have substantially, but not fully, performed its contractual obligations. This would mean that the performing party could still be subject to a claim by the other party for any provable difference in cost or value between the performance rendered and the performance promised in the contract. *See, e.g. Jacobs & Young, Inc., supra.*

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For the foregoing reasons, it is our view that the Continuity of Contract statute applies by its express terms to both existing and future contracts, securities and other instruments that involve currencies that are replaced by the euro. We also believe that, properly construed, the application of the Continuity of Contract statute to existing contracts is not invalid under the United States or New York constitutions. If you have any questions please call William M. Dallas, Jr. at (212) 558-3660, Michael M. Wiseman at (212) 558-3846 or Rebecca J. Simmons at (212) 558-3175.

SULLIVAN & CROMWELL