



**ECONOMIC AND MONETARY UNION**

**THINKING THE UNTHINKABLE - THE BREAK-UP OF  
ECONOMIC AND MONETARY UNION**

by

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## **CONTENTS**

- Background
  
- Thinking the Unthinkable - The Break-up of Economic and Monetary Union
  - Overview
  - Monetary Consequences of EMU
  - A Member State Leaving EMU?
  - Negotiated Withdrawal
  - Unilateral Withdrawal
  - Conclusions
  
- Contact Details

## **BACKGROUND**

This is the latest in a series of Briefings issued by Norton Rose on the topic of Economic and Monetary Union. On 2nd September 1996, Norton Rose issued a Briefing entitled "EMU - Business as usual in the Financial Markets", which contained a detailed, legal analysis of the impact of EMU on financial obligations.

That Briefing was issued against the background of numerous concerns - raised in many sections of the legal community and echoed in the financial markets - that the advent of EMU might result in the termination or frustration of contracts governed by English law. The Briefing exploded these myths and demonstrated that English commercial law was robust enough to take EMU in its stride. This view is now almost universally accepted in the City.

Further Briefings were published in October 1996, May 1997, September 1997 and January 1998. These dealt with subsequent developments in the field, including:

- the legal framework for EMU;
- the impact of the three-year transitional period;
- the redenomination and renominalisation of debt securities;
- the replacement of reference rates and price sources;
- the institutional and financial structure of EMU;
- consequences of EMU for the debt and equity markets;
- opportunities created by EMU;
- opportunities for the securitisation market.

This Briefing considers the (remote) possibility which has recently been floated in certain sectors of the financial markets - what will happen if monetary union - once established - cannot be maintained?

## **ECONOMIC AND MONETARY UNION**

### **THINKING THE UNTHINKABLE - THE BREAK-UP OF ECONOMIC AND MONETARY UNION**

#### **OVERVIEW**

February and March 1998 have been significant months for Economic and Monetary Union. A number of Member States released figures detailing whether they were on course to meet the economic benchmarks (the well-known "Maastricht Criteria") required to qualify for EMU participation. Of the fifteen Member States, three States - the United Kingdom, Sweden and Denmark - had already announced that they would not be joining EMU in the first wave. Of the remaining twelve States, eleven have been found substantially to meet the Maastricht criteria. On 25th March, the European Commission and the European Monetary Institute published reports on Member States which are held to meet the Maastricht Criteria and thus qualify for EMU. The result is that it now seems almost certain that eleven Member States will participate in the first wave of EMU on 1st January 1999.

Many predicted that EMU would not happen. But numerous political and economic difficulties have been surmounted and it now seems clear that EMU will proceed in accordance with its set timetable; the euro will become a reality on 1st January 1999. Now that EMU appears to be a certainty, the sceptical mind is obliged to identify another target. Against this background, many people (pessimists or realists, depending upon one's standpoint) have turned their minds to the possibility of an EMU collapse after its launch on 1st January next year. If EMU has to happen, perhaps it will collapse at a later date! The possibility of an EMU breakdown has commanded some serious attention in some financial and economic circles<sup>1</sup>; it therefore deserves consideration from a legal standpoint.

This Briefing therefore addresses the unthinkable: the legal consequences of the break-up of Economic and Monetary Union.

#### **MONETARY CONSEQUENCES OF EMU**

As noted earlier, Economic and Monetary Union now seems almost certain to take place on 1st January 1999. Once established it is extremely unlikely that the process would or could be reversed. Indeed, after the third stage of EMU has begun it will - in strict legal terms - be *impossible* to return to the pre-EMU position because:

- (a) previous currencies of participating Member States (often referred to as "legacy currencies") will cease to exist on 1st January 1999; and
- (b) accordingly, it will not be possible simply to "resurrect" them.

This is not merely a dry legal point - it also has economic and political implications. The individual, national currencies of participating Member States will cease to have any independent existence from 1st January 1999. Deutschmarks, French francs and other currencies will cease to exist. It is true that, for a three year transitional period, the physical indicia of such currencies (in the form of notes, coins and bank accounts) will continue to circulate and be available; but these will be mere "representations" of the euro, at the prescribed (and fixed) conversion rates. Bank accounts denominated in euro will be available in participating Member States from 1st January 1999.

Put shortly, it will not be possible to turn back the clock. Once a national currency is abolished (and, for the purposes of EMU, this will occur on 1st January next year), then its demise is irrevocable; it cannot be restored to life.

But economic or political considerations could conceivably lead a Member State to seek an exit from EMU, and to seek to create a new national currency. What would be the legal implications of a withdrawal from EMU by one or more participating Member States?

### **A MEMBER STATE LEAVING EMU?**

First of all, it is necessary to consider a few specific issues. Although they may appear to be of a technical nature, it should be remembered that these points arise from the Treaty on European Union as signed at Maastricht on 7th February 1992 (hereafter the "Maastricht Treaty") and thus go to the very heart of monetary union<sup>2</sup>. First of all, it must be remembered that monetary union is intended to be an irrevocable process<sup>3</sup>. It follows that (i) the EMU process necessarily involves an irrevocable delegation of national monetary sovereignty<sup>4</sup> to EC institutions (including the European System of Central Banks) and (ii) any attempt by an EMU participating State to re-establish a separate national currency would (in the absence of consent from other participant States) necessarily represent a breach of the Maastricht Treaty. No mechanism exists in the Maastricht Treaty which allows a participating Member State to withdraw from EMU. Indeed, even non-participating Member States are required to respect the momentum towards EMU<sup>5</sup>. The Member States have also confirmed the "...irreversible character of the Community's movement to the third stage of Economic and Monetary Union..."<sup>6</sup>

It is important to note the sheer enormity of the effect of a possible withdrawal from EMU by a Member State. It would not be a mere repeat of "Black Wednesday" when the UK withdrew sterling from the Exchange Rate Mechanism ("ERM"). The ERM was (and is) simply a mechanism to peg the exchange rate levels of the currencies of Member States to each other within certain bands. The exchange rates do vary within these bands and control of each Member State's individual currency, monetary policy, reserves and potential liabilities remain with that Member State's central bank under its own jurisdiction. But a Member State could (and can) leave the ERM without any particular *legal* difficulty, because its own national currency remains intact and retains a legal existence which is separate from other currencies within the mechanism. The same general observations will apply to the ERM structures which are to be put in place at the beginning of the third stage of EMU<sup>7</sup>.

Economic and Monetary Union is totally different because (i) a *single* currency is created and (ii) a new - and supranational - institutional infrastructure is being put in place to oversee the new currency and monetary policy. The consequences of the introduction of a single currency are wide-ranging. The following treaty consequences should be noted:

- (a) On 1st January 1999, the individual currencies of participating Member States will cease to exist and will be converted into the euro at fixed rates;
- (b) Control of the euro will vest in a new body, the European System of Central Banks ("ESCB"), which consists of (i) the Central Banks of participating Member States and (ii) the newly created European Central Bank ("ECB"). The ESCB will have the exclusive power to conduct the exchange rate and monetary policy of the euro-zone with a view to the maintenance of price stability<sup>8</sup>, and will also be responsible for the holding and management of the official reserves of the participating Member States;
- (c) The initial capital of the ECB will be 5,000 million euro, which is to be subscribed by the national Central Banks in accordance with an agreed weighting formula<sup>9</sup>;
- (d) On 1st January 1999, the national Central Banks will also be required to provide a total of 50,000 million euro in foreign reserve assets to the ECB<sup>10</sup>. These foreign reserve assets will be provided on a pro rata basis by reference to the amount of capital provided by each of the national Central Banks<sup>11</sup>.

Since the EMU process is intended to be irreversible, it is unsurprising that the Maastricht Treaty is silent on the implications of a withdrawal by one (or more) participating Member States from the EMU process. But

political and economic realities do not always observe the finer points of international treaties - even those concluded in a multilateral framework against the institutional background of the Community.

As noted earlier, withdrawal from EMU must be a remote possibility once the euro is established on 1st January 1999. If the initiation of multilateral negotiations with a view to EMU withdrawal are difficult to contemplate, then a unilateral withdrawal (i.e. without the consent of other Member States) must be an even more remote possibility; but a general discussion of this subject can only be complete if both aspects are considered. This Briefing will therefore consider both possibilities. In each case, the consequences of withdrawal on financial obligations will be considered; it is thought that the impact of EMU withdrawal on monetary obligations may be different in each case.

## **NEGOTIATED WITHDRAWAL**

The States which are party to a treaty are, of course, free to agree any amendment or variation to its terms at any time. Although concluded specifically within a Community context, the same principle applies to the provisions of the Maastricht Treaty.

This straightforward principle would, however, clearly translate into fairly tense negotiations between the withdrawing State and the continuing, EMU-participant States. At a financial level, the following issues would arise:

- (a) clearly, the withdrawing State would need to create a new, national currency in substitution for the euro within its own national borders;
- (b) the withdrawing State will have contributed its initial portion of the capital of the ECB. Since the national Central Bank of the withdrawing State would cease to be a member of the ESCB, it would presumably seek a refund of these amounts in order to support its new currency;
- (c) since monetary union necessarily involves a pooling of the foreign reserve assets of participating States - and profits and losses will accrue to the pool over a period - the withdrawing State will presumably seek reimbursement of the foreign reserves contributed by it to the ECB, plus its share of any accrued profits but net of its share of losses<sup>12</sup>;
- (d) in practice, of course, matters will not be so straightforward. The Maastricht Treaty does not allow for the withdrawal of contributed capital or reserves from the ECB, and financial terms would require a new negotiation. Such negotiations would be complicated by a number of factors; in particular, the withdrawal of a Member State would clearly shake market confidence in the euro and would be likely to lead to extreme volatility in its external value. This could only be mitigated by (i) a retention of a portion of the contribution of the withdrawing State and/or (ii) an additional financial contribution to the ECB by participating Member States in order to support the euro. It is quite likely that the available funding within the ECB itself would be insufficient (i) to support the euro adequately *and* (ii) to support the creation of a new national currency by the withdrawing State. This, in turn, might render it impossible to negotiate "exit" terms without placing the entire EMU process under impossible strain;
- (f) it will be apparent that withdrawal from EMU by a participating Member State will have major implications both for the withdrawing State and the continuing participants. For the departing State, there will be the costs of establishing a new national currency and the uncertainty of its external value. This uncertainty is likely to endure for a lengthy period given the need to renegotiate the monetary aspects of the Maastricht Treaty and the inevitable complexity of the transitional arrangements which would have to be put in place. The scale of the costs and liabilities involved - and the difficulty of quantifying them with any precision - must of themselves be very significant deterrents to any attempt by a participating State to negotiate a withdrawal. For those States which continue to form a part of the euro zone, the very existence of such negotiations would clearly have an adverse impact on the value of the euro and on their financial markets generally;

- (f) if the EMU process ran into difficulties very early during its third stage (i.e. before the end of the transitional period) then it might be thought that the withdrawal of an individual participant would be facilitated, because physical notes and coins issued in the old national currency would continue to exist; bank accounts in that currency would also continue to be available. But in fact, this would be illusory; the national currency will have ceased to exist and its notes/coins will be mere representations of the euro. The outgoing Member State would therefore have to create a new currency and there is no guarantee that the old notes/coins could be used for this purpose. Certainly, there would be no obligation on a Member State to act in this way in establishing its new currency. The withdrawing Member State would also have to deal with outstanding bank accounts expressed in euro, and this may also prove to be problematical (especially in the context of accounts held by non-residents).

For present purposes, it must be assumed that all of the above barriers to withdrawal can be overcome and that a departing Member State has negotiated satisfactory terms for its withdrawal from the euro zone. What would be the implications for financial or payment obligations? We shall use as an example a Dutch guilder denominated bond, with the Netherlands being the Member State withdrawing from EMU. It should be emphasised that this example is used purely in order to illustrate the points about to be made - it is not thought to represent a likely scenario!

What, then, are the consequences for a bond or other obligation expressed in Dutch guilders where (i) the Netherlands pulls out of EMU and (ii) the bond or obligation falls due for payment after the effective date of the Dutch withdrawal?

The essential question would be - is the bond required to be repaid in euro, or would the obligations under it be satisfied by a payment in the new Dutch currency at the rate prescribed by the new Dutch currency law? The difficulties involved in answering this question are compounded by the fact that the euro continues to exist as the lawful currency of the remaining participant States and is thus available as a medium for payment, notwithstanding the "exit" of the Netherlands from the euro zone. In general terms, it is suggested that the following rules should be applied:

- (a) if the bond (i) was expressed in Dutch guilders (i.e. it was originally issued before 1st January 1999), (ii) was stated to be payable solely within the Netherlands (i.e. there are no "external" paying agents) and (iii) was issued by a Dutch entity, then it must follow that the bond was clearly intended to be issued within the Dutch domestic markets and thus denominated in the lawful currency of the Netherlands. It ought to follow that the obligation is to be met in the new Dutch currency. This is because States generally recognise the right of other States to regulate their own domestic currencies, and matters relevant to such a currency are therefore referred to the laws of the issuing State (the "lex monetae" principle)<sup>13</sup>. In such a case, the English courts would generally adopt the exchange rate (euro - new Dutch currency) prescribed by the new Dutch monetary law<sup>14</sup>. The international obligation of the United Kingdom to recognise the Dutch monetary law<sup>15</sup> is reinforced by the fact that the United Kingdom would be party to any international agreement amending the Maastricht Treaty, and the English courts will generally endeavour to act in a manner consistent with this country's treaty obligations;
- (b) if the bond was issued after 1st January 1999, then it will be expressed in euro and there will be no direct, contractual link to the former Dutch national currency. But if the debt is payable within the Netherlands, then it is suggested that debtor can discharge the obligation either (i) by payment in euro, since the obligation is expressed in that currency or (ii) by payment in the new Dutch currency, because the law of the place of payment may be taken into account in determining the means or method of payment<sup>16</sup>. In the latter case, the appropriate rate of exchange between the euro and the new Dutch currency would be governed by the law applicable to the instrument or obligation in question - the courts would not necessarily adopt the exchange rate prescribed by the new Dutch monetary law<sup>17</sup>;
- (c) if the bond was issued after 1st January 1999 but is expressed to be payable in euro outside the Netherlands, then it seems that the alteration in the Dutch currency should be irrelevant. Performance

of the obligation in euro in the stipulated place of performance is entirely possible, because the euro remains the currency of the other, EMU-participant States. This rule would continue to apply even if the issuer were a Dutch-incorporated entity;

- (d) the change in Dutch currency should not have the effect of terminating or frustrating the obligation, at least if the contract or instrument in question is governed by English law<sup>18</sup>;
- (e) where a contract is converted from the euro to a "new" national currency, clauses stipulating for a floating rate of interest will be deemed to refer to an appropriate price source for the new currency<sup>19</sup>.

Whatever the financial position and political implications may be, it seems clear that an EMU withdrawal by a Member State would create a number of difficult legal issues, but these difficulties should be capable of resolution against the background of a renegotiation of the Maastricht Treaty.

### **UNILATERAL WITHDRAWAL**

If a negotiated withdrawal is difficult to contemplate, it is almost impossible to envisage circumstances in which a participating Member State could unilaterally withdraw from EMU.

As noted above, the Maastricht Treaty does not provide for unilateral withdrawal or termination by a participant State. Although a right of termination may, in some cases, be implied into a treaty<sup>20</sup> there are no grounds for such an inference in the context of the Maastricht Treaty, which is expressed to create an "irreversible" and "irrevocable" monetary union. A State may also acquire the right to terminate a treaty under other circumstances (e.g. supervening impossibility of performance or the occurrence of certain changes in circumstances which radically affect the nature of any obligations which remain to be performed<sup>21</sup> under the Treaty concerned), but again it is difficult to see how a right of termination could arise under these provisions. It follows that a unilateral withdrawal from the Maastricht Treaty would constitute a clear breach of a treaty obligation owed to other Member States. The continuing Member States may have claims for compensation against the departing State and may be entitled to take counter-measures, for example by withholding moneys or benefits due to the departing State under other treaties<sup>22</sup>. But the financial markets would be concerned with more mundane matters - what are the consequences of a unilateral withdrawal in the context of monetary instruments or obligations? The following points appear relevant in this context:

- (a) once again, the withdrawal from the euro zone necessarily involves the creation of a new national currency by the departing State, and the introduction of a new monetary law in that State;
- (b) no doubt the courts of the withdrawing State would give effect to the new, national monetary law in accordance with its terms;
- (c) however, it is suggested that the English courts would refuse to give effect to the currency change in the withdrawing State on the grounds that (i) the monetary law would have been enacted in breach of a treaty to which the United Kingdom is itself a party<sup>23</sup> and (ii) recognition of the monetary law would be manifestly incompatible with the public policy of the European Community and (consequently) of England<sup>24</sup>. Thus if (in our example) an action were brought before the English court on a euro-debt instrument issued by a Dutch entity, then an English court would (i) disregard the Dutch monetary law which sought to vary the currency of obligation and (ii) give judgment expressed in euro<sup>25</sup>.

Quite apart from the financial and political risks which a unilateral withdrawal would provoke, the departing State would have to accept that its new currency may not be recognised in other Member States - at least until a settlement of the situation had been negotiated. The departing State - and entities carrying on business within it - would thus be exposed to new exchange risks. These risks would be very difficult to quantify at the point of departure, given the uncertain value of the new national currency and the impact of the departure upon the value of the euro.

## CONCLUSIONS

In conclusion, it may be noted that the advent of EMU is generally expected to break down many of the remaining barriers to cross-border trade and investment within the European Community. If one takes the view that the withdrawal of one or more Member States is a possibility, then there may be residual questions of currency risk even in the post-EMU period. But in practical terms, it is impossible for international businesses to guard against this risk. The euro becomes the single currency of participant Member States from 1st January next year, and existing national currencies disappear. An EMU "exit" necessarily involves the creation of a brand new national currency; and it is not possible to hedge against the emergence of a new currency which may never come into existence.

Finally, it must be emphasised that a withdrawal from EMU - whether negotiated or unilateral - by one or more participant States must be an extremely remote prospect. A Member State which sought to withdraw would invite serious dislocation to its own economy and to its financial markets.

For these reasons, any stresses which arise within the euro zone as a result of differing national or economic priorities would inevitably require a political (negotiated) settlement. They are not susceptible to a purely legal analysis or solution.

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## ENDNOTES

- 1 See, for example, page 3 of The Financial Times Survey on Economic and Monetary Union, published on 23rd March 1998.
- 2 For convenience, reference will be made throughout to the "Maastricht Treaty", although the relevant Articles are in fact contained in the EC Treaty, as amended at Maastricht.
- 3 This point is confirmed by Article 109I(4) of the Maastricht Treaty, which refers to the fixed rates at which the euro will be substituted for participating currencies.
- 4 This delegation of monetary sovereignty is clearly evidenced by various provisions of the Maastricht Treaty, including Articles 105-109 dealing with the conduct of monetary policy.
- 5 See, for example, the Tenth Protocol to the Maastricht Treaty, which requires all EC Member States (whether EMU participants or not) to "... respect the will for the Community to enter into the third stage..." of monetary union and accordingly "... no Member State shall prevent the entry into of the third stage..."
- 6 See the Tenth Protocol to the Maastricht Treaty.
- 7 On this subject, see the Resolution of the European Council on the establishment of a new ERM (Amsterdam, 16th June 1997)
- 8 The maintenance of price stability is the primary objective of the ESCB - see Article 105 of the Maastricht Treaty.
- 9 Article 28 and Article 29 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.
- 10 Article 30.1 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.
- 11 Article 30.2 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.
- 12 National central banks are to receive their pro rata share of the ECB profits/losses in accordance with their key ratios. However, up to 20 per cent. of the net profits are to be transferred to a general reserve fund of the ECB - see Article 33 of the ESCB Statutes.
- 13 See the Norton Rose Briefing "EMU - Business as Usual in the Financial Markets".
- 14 *Anderson v Equitable Assurance Society of the United States* (1926) 134 LT 557; *Sternberg v West Coast Life Assurance Co.* 196 Cal App 2d 519 (1961).
- 15 The authority usually cited for this obligation is the decision of the Permanent Court of International Justice in the *Serbian and Brazilian Loans* case (1929) PC IJ Series A Nos 20-21.
- 16 This will usually be the position in the context of a contractual payment obligation - see Article 10(2) of the Rome Convention on the Law Applicable to Contractual Obligations, as incorporated into English law by the Contracts (Applicable Law) Act 1990.
- 17 *Atlantic Shipping and Trading Co v Louis Dreyfus & Co* [1922] 2 AC 250; *Marrache v Ashton* [1943] AC 311.
- 18 *British Movietonews Ltd v London and District Cinemas Ltd* [1952] AC 166.
- 19 *BCCI v Malik* [1996] BCC 15.
- 20 Article 56 of the Vienna Convention on the Law of Treaties. The Vienna Convention is to be applied in a Community context - *Opel Austria GmbH v Council* [1997] ECR-II 0039; *Danisco Sugar AB v Allmänna* (Case C-27/96).
- 21 On supervening impossibility and changes in circumstances, see Articles 61 and 62 of the Vienna Convention on the Law of Treaties.
- 22 See, for example, USA-France Air Services Agreement (1978) 54 ILR 304.
- 23 *Royal Hellenic Government v Vergottis Ltd* (1945) 78 Lloyds List Rep 292.
- 24 Article 16 of the Rome Convention on the Law Applicable to Contractual Obligations. In principle, courts sitting in other EC Member States should reach the same conclusion.
- 25 The English court could give judgment expressed in euro in reliance on the decision in *Miliangos v George Frank (Textiles) Ltd* [1976] AC 443, and subsequent decisions.

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