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Bail-Out Turns to Bail-In: Europe Anticipates Next Financial Crisis

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The term “bail-out” became ubiquitous during the recent financial crisis. Its counterpart, “bail-in,” is now rapidly becoming equally well-recognized and, at least in some circles, just as controversial.

Bail-out is, of course, when outsiders, be it government or private, rescue a distressed institution by injecting capital or providing other financial support. By contrast, in a “bail-in” it is the creditors to the distressed institution that bear the risk of its failure through a forced reduction or conversion to equity of debt.¹ The term bail-in has recently become closely associated with the EU Bank Recovery and Resolution Directive (BRRD).²

The BRRD became effective in most EU countries in January 2015 as part of a broader series of reforms intended to avoid, or at least minimize, the disruption to the financial system experienced during the recent economic meltdown. Given that it is a directive, it must be implemented separately by individual member states.³ The BRRD applies to EU member states, as well as members of the European Economic Area (EEA).⁴ Its objective is to enact laws designed to permit the restructuring of debts of distressed financial institutions through “resolution proceedings.” However, the BRRD is also seeking to assure full cross-border recognition of these resolution proceedings. Article 55 of the BRRD is its means to effect this recognition.

Article 55 provides for the contractual recognition of “bail-in” provisions. These provisions are already appearing in U.S. credit agreements and, in so doing, are generating some controversy and uncertainty. Today we will examine the BRRD and how Article 55 fits within that framework. We will then discuss how the “bail-in” affects secured transactions, as well as highlight some relevant issues for legal counsel.

The BRRD

The BRRD grants broad powers to regulators to take “resolution” action, including to convert into equity, cancel or write-down liabilities of a covered financial institution.⁵ Ultimately, through the BRRD, resolution

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authorities of individual member states have the discretion to decide whether a “bail-in” is required by examining the following three questions. Is the institution failing or likely to fail? Are there any feasible alternative private sector measures other than bail-in? Is action necessary to further the public interest?⁶

If a resolution is necessary, the BRRD provides a range of tools to facilitate the bail-in. One such tool is Article 43, which establishes the “bail-in” powers.

The *precise* scope of covered entities is complex and beyond the reach of this

article. Broadly defined, however, covered entities subject to bail-in include (x) any EEA credit institution or investment firm subject to supervision of an EEA resolution authority or any EEA parent of any such institution or firm or (y) a subsidiary of any of the foregoing established in the EEA and subject to consolidated supervision with its parent.⁷ In other words, bail-in (and so Article 55) applies to U.S. branches of EEA banks and to EEA subsidiaries of U.S. credit institutions and investment firms, but not to EEA branches of U.S. banks nor to U.S. subsidiaries of EEA firms.

Article 44 of the BRRD provides that all liabilities that are not expressly excluded are covered. Certain types of liabilities are in fact specifically carved out from the bail-in powers, including liabilities to employees and to certain suppliers, EU insured deposits, deposits under 100,000 Euros by small and medium sized companies, liabilities with a maturity of less than seven days to unaffiliated banks, and secured liabilities (but only to the extent they remain fully secured).⁸ Notably, although secured obligations are not subject to bail-in, unsecured liabilities that form part of a secured transaction would be covered: including lending commitments, indemnities typically provided to the facility and security agent and the letter of credit bank, confidentiality obligations, intercreditor agreement restrictions, requirements to notify the borrower under certain circumstances, and administrative obligations, such as tax status, information and notifications.

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Any agreement or provision under an agreement governed by the law of an EEA member country is automatically subject to the “bail-in” powers of the resolution authority, regardless of its terms. Article 55 provides the mechanism through which the bail-in powers can be exercised over liabilities of covered entities governed by non-EEA law.⁹ More specifically, Article 55 requires a covered entity to include a contractual term in its agreements whereby any counterparty entitled to enforce contractual claims against such covered entity recognizes and agrees to be bound by the reduction or conversion to equity of such claims by the applicable resolution authority.¹⁰

When did, or does, Article 55 become effective? The BRRD required each EU member state to implement Article 55 by no later than Jan. 1, 2016,¹¹ although some states implemented the provision earlier than this,¹² and some have missed the deadline.¹³ Moreover, the non-EU EEA member states have yet to implement Article 55.¹⁴ Once effective, Article 55 applies to liabilities issued or entered into (including those acquired through loan transfers) after the effective date (regardless of when the underlying agreement was entered into), liabilities under debt instruments issued after the effective date, as well as liabilities that were created, either directly or through a debt instrument, under an agreement that is “materially amended” after the effective date.¹⁵ In somewhat tortured fashion, current draft implementing regulations define a material amendment in the negative, namely as an amendment that is not a non-material amendment, and then go on to define a “non-material amendment” as an amendment that does not affect the substantive rights and obligations of a party.¹⁶

Bail-In and U.S. Credit Agreements

Because EEA-based financial institutions are a major part of the U.S. primary and secondary syndicated loan markets, Article 55 has quickly become a focus of attention here. For example, in December 2015 (just in advance of the mandated effective date for Article 55), the Loan Syndications and Trading Association (LSTA) in the United

States, and its counterpart organization in Europe, the Loan Market Association (LMA), concurrently issued model recommended bail-in recognition clauses to be used in EEA (in the case of the LMA) and New York (in the case of the LSTA) governed loan documents. However, the provisions, while generally consistent, are not identical and reflect, among other things, differences in loan market practices, terminology, structure and governing law, as well as differing perspectives regarding potential future use of these forms.¹⁷

So what are the mandatory features of an Article 55 bail-in recognition clause? The draft implementing regulations for Article 55 did not contain model provisions, but rather require that each bail-in recognition provision contains a description of the regulatory write-down and conversion powers, as well as an acknowledgement and acceptance by

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the financial institution counterparty that (a) its claims may be subject to those powers, (b) it is bound by the effect of such powers, (c) the terms of the relevant documents may be varied in connection with the exercise of such powers, (d) covered liabilities can be written down or converted into equity as a result of the exercise of such powers and (e) the bail-in recognition provision supersedes any other contractual term between the parties.¹⁸

In addition, and importantly for U.S. counsel, the BRRD specifies that, depending on the national implementing legislation, covered entities with liabilities governed by a non-EEA agreement may be required to provide resolution authorities with a local law opinion relating to the enforceability of the bail-in recognition clause.¹⁹ Specifically, counsel would be required to opine as to whether the write-down or conversion powers of the relevant resolution authority would be given effect under local law.

While Article 55 of the BRRD directs EEA countries to provide resolution authorities with the discretion to require legal opinions on enforceability,²⁰ implementation of this directive has not been uniform. The majority of member states however, have implemented the enforceability opinion requirement along with the rest of Article 55.²¹ For example, the United Kingdom, in connection with certain liabilities, requires covered institutions to provide the resolution authorities with “a properly reasoned independent legal opinion from an individual appropriately qualified in the relevant third country on the enforceability and effectiveness” of bail-in recognition provisions required by Article 55.²² That said, it is still unclear at this point whether other resolution authorities will make such requests and, if so, what the scope and the circumstances of those requests will be.

Moreover, whether such clauses are enforceable under New York and other state laws is also an open question. Currently there is no indication of forthcoming harmonization between the EEA countries and other jurisdictions to give prospective assurance that bail-in clauses satisfying Article 55 will be enforceable in non-EEA jurisdictions. Absent any such indication of cooperation or other notice from regulators, and given that Article 55 specifically targets provisions and agreements not governed under EEA law, this may well be a question decided by courts pursuant to the local law governing the provision at issue and may be decided taking into account principles of international comity.

It also remains to be seen what market practice will emerge in regard to whether bail-in clauses will be covered by transaction opinions issued by external counsel. The market is still in its early stages and current market practice for these opinions seems inconsistent, although the many opinions exclude bail-in clauses and include qualifications as to the effect of resolution powers.

The general presumption is that agreements freely entered into by parties are enforceable, absent some reason that renders them void. Article 55 certainly

affects the rights of creditors that have no connection with the EEA other than lending to entities covered by the scope of Article 55. Indeed, because it derogates from a lender's rights under the local law governing the agreement in question, it arguably seeks to affect procedural and statutory rights provided under local law through foreign regulatory intervention. This accordingly raises public policy questions, which should be considered in the context of these opinions.

Conclusion

Perhaps comity considerations and the hope that EEA institutions would reciprocally cooperate with U.S. resolution authorities in the event of crisis would dissuade U.S. courts from entertaining public policy challenges against enforcement. But perhaps the only certainty at this point is uncertainty. Ultimately, the extent to which New York or other non-EEA courts will enforce Article 55's required bail-in provisions can only be known with certainty upon the resolution of a covered entity with liabilities covered by a bail-in recognition provision.



1. The Economist, "The Economist Explains: What is a bail-in?" April 7, 2013, <http://www.economist.com/blogs/economist-explains/2013/04/economist-explains-2>.

2. Directive 2014/59/EU of the European Parliament and of the Council (hereinafter BRRD).

3. This of course creates the potential for non-uniform provisions. As of Feb. 1, 2016, out of all the member states of the European Economic Area (hereinafter EEA), Poland and the three non-EU EEA states, Iceland, Liechtenstein and Norway (further explained in *infra* note 4) have not yet implemented the BRRD. Loan Market Association, EU Bail-In Legislation Schedule, Feb. 1, 2016, <http://www.lma.eu.com/documentsdownload.aspx?T=1&CID=2555>; See accord International Swaps and Derivatives Association, ISDA BRRD Implementation Monitor (hereinafter "BRRD Monitor"), Jan. 7, 2016, http://www2.isda.org/attachment/ODEwNQ==/BRRD_Implementation%20Monitor_v3.1_Jan16.pdf (outlining the various schemes for implementation of the BRRD across EEA countries).

4. Unlike with EU Member States, the BRRD is not automatically applicable to the EEA, which is comprised of all 28 EU Member States plus Norway, Liechtenstein, and Iceland. As such, even though the BRRD is intended to apply to the EEA, the EEA Joint Com-

mittee has yet to do so as of the date of this article. See European Free Trade Area (hereinafter EFTA), The EEA Agreement: List of adopted Joint Committee Decisions, <http://www.efta.int/legal-texts/eea/list-of-adopted-joint-committee-decisions-jclds>.

Switzerland is not part of either the EU or the EEA, and is thus not obligated to adopt the BRRD. Nonetheless, Switzerland has adopted similar legislation that deals with the issues addressed by the BRRD. See "BRRD Monitor," *supra* note 3.

With those caveats in mind, because the EEA is anticipated to adopt the BRRD, we discuss the bail-in provisions with the assumption that it will be implemented by all EEA member states.

5. European Commission, "Memo: A Single Resolution Mechanism for the Banking Union—frequently asked questions," April 15, 2014 (http://europa.eu/rapid/press-release_MEMO-14-295_en.htm).

6. BRRD, Art. 32 (1).

7. BRRD, Articles 1(c), 1(d) and 1(b).

8. BRRD, Article 44 (2), Article 108 (a), Article 55 (1)(a), (b).

9. BRRD, Article 55 (1)(c). Article 55 relates solely to the bail-in clause for contracts governed by the laws of non-EEA countries, but not to the bail-in itself, which is governed by other articles of the BRRD.

10. BRRD, Article 55(1).

11. BRRD, Article 130.

12. Hungary was the first Member State to implement Article 55, which it did on Sept. 16, 2014. See Act XXXVII of 2014 on the further development of the system of institutions strengthening the security of the individual players of the financial intermediary system, §72 (<https://www.mnb.hu/letoltes/2014-evi-xxxvii-tv-nem-hivatalos-angol-forditasa-pdf.pdf>).

13. Poland has yet to implement Article 55 or the other provisions of the BRRD and has been referred to the European Court of Justice for its failure to do so. See "BRRD Monitor," *supra* note 3; see also European Commission, Press Release: Commission refers six Member States to the Court of Justice of the EU for failing to transpose EU rules on Bank Recovery and Resolution (http://europa.eu/rapid/press-release_IP-15-5827_en.htm).

14. The EEA members are not bound by the Jan. 1, 2016 implementation deadline. While the BRRD has been marked EEA relevant, it is not currently under formal consideration by EEA Members. See Adopted EU acts marked EEA relevant or considered EEA relevant by EEA EFTA experts, March 29, 2016, http://www.efta.int/media/documents/legal-texts/eea/other-legal-documents/list-eu-acquis-marked-or-considered-eea-relevant/weekly_list.pdf; Draft Joint Committee Decisions under consideration by the European External Action Service and the EEA EFTA States (http://www.efta.int/media/documents/legal-texts/eea/other-legal-documents/list-draft-jclds-under-consideration-by-efta-and-eeas/weekly_list.pdf).

15. European Banking Authority, "Final Report: Draft Regulatory Technical Standards Under Article 55(3)" (hereinafter Draft RTS), Article 2(2), July 3, 2015, <http://www.eba.europa.eu/documents/10180/1132911/EBA-RTS-2015-06+RTS+on+Contractual+Recognition+of+Bail-in.pdf>.

16. Draft RTS, Article 1(2) and (3). While the RTS does not give examples of "material amendments," it does give examples of amendments that would not be "material," which include "a change to the contact details of a signatory or the addressee for the service of documents, typographical changes to correct drafting errors or automatic adjustments of interest rates."

17. Loan Market Association (LMA) and Loan Syndications and Trading Association (LSTA), EU Bail-in Rule—Publication of LMA and LSTA Contractual Recognition Clauses, Dec. 22, 2015, <http://lsta.org/uploads/DocumentModel/1972/file/lma-lsta-brrd-statement-december-2015.pdf>.

18. The Draft RTS further details the exclusions and contractual clause requirements of Article 55. See *supra* note 15. According to the Final Report, "[t]he draft RTS will be submitted to the Commission for endorsement before being published in the Official Journal of the European Union. The technical standards will apply from on the twentieth day following that of its publication in the Official Journal of the European Union."

19. BRRD, Article 55(1).

20. *Id.*

21. See "BRRD Monitor," *supra* note 3 (referring to the Law on Recovery and Resolution of Credit Institutions and Investment Firms, <http://likumi.lv/doc.php?id=275045> (the only country reported not to have implemented the enforceability opinion requirement is Latvia)).

22. Bank of England: Prudential Regulation Authority (hereinafter PRA), The PRA Rulebook: CRR Firms and Non-Authorized Persons: Contractual Recognition of Bail-in Instrument 2015, Article 2.2 and 3.3, http://www.prarulebook.co.uk/rulebook/Media/Get/20558c6e-5bd7-4f13-9d3d-b2b2d08692a2/PRA_2015_5/pdf (For the full policy statement in which the PRA Rulebook is appended, see Policy Statement | PS1/15: Implementing the Bank Recovery and Resolution Directive—response to CP13/14, January 2015, <http://www.bankofengland.co.uk/pradocuments/publications/ps/2015/ps115.pdf>).