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US Loan Market Adapts to European Bail-In Directive

LSTA publishes model provisions for use in US law-governed credit agreements to assist in adopting new EU bail-in rules.

European Economic Area (EEA) financial institutions are now subject to a new set of regulatory requirements designed to avoid taxpayers bailing out banks in the event of another banking crisis — a central component of which is that EU member state bank regulators have been provided with broad new "bail-in" powers to write down (including to zero), convert to equity or otherwise modify unsecured liabilities of failing financial institutions.

These new rules require an "EEA financial institution" (defined below) to include a "contractual recognition of bail-in clause" in almost every document to which it is a party that is governed by the law of a non-EEA country under which the institution incurs or could incur any unsecured liability. By dint of the contractual recognition provision, the other parties to the contract acknowledge that an EU resolution authority action may impair the financial institution's liabilities, and the other parties agree to be bound by the effects of such impairment. While somewhat non-intuitive, these rules extend to agent and lender obligations in financing transactions. This includes not only their commitments to lend but also their indemnification, confidentiality, reimbursement, sharing, turnover and other intra-lender obligations, as well as related potential liabilities grounded in non-contractual claims such as those based on negligence or misrepresentation.

US Loan Market Adoption

To assist with US market adoption of these so-called "contractual recognition" provisions, the Loan Syndications and Trading Association (the LSTA) has published model provisions designed for use in all US law-governed credit agreements. Initial indications suggest that market participants will expect the LSTA contractual recognition provision to be included in all loan documentation regardless of whether an EEA financial institution is an original party to the arrangements, as the absence of the clause could impair primary syndication and secondary loan trading to European financial institutions. Indeed, it is expected that over time the contractual recognition of bail-in provisions likely will become part of the boilerplate for virtually all large corporate syndicated lending transactions in the US.

Inclusion in Ancillary Documents

In addition to adding contractual recognition provisions to credit agreements, corollary provisions should be added to the following types of documentation used in connection with lending commitments and other credit arrangements:

- Commitment and engagement letters in the event that any arranger or initial lender may be an EEA financial institution

- Term sheets to the effect that the definitive loan documentation will contain the EU bail-in contractual recognition provisions

- Other loan documents under which the agent (or any other lender) assumes any indemnification, reimbursement, sharing, turnover, confidentiality, or other payment or performance obligations (*e.g.*, intercreditor agreements, agreements among lenders, security agreements, guaranties and other collateral documents), obligations to obtain consent, restrictions on creditor actions, or administrative agent responsibilities, including to provide notices and distribute borrower information. In practice, market participants may decide to simply include cross-references back to the contractual recognition provision in the primary credit agreement to which such ancillary documents relate.

Material Amendments/Incrementals/Secondary Purchases and "Impracticability"

Contractual recognition provisions are required not only in new agreements, but should be included as part of any "material amendment" of an existing contract. In connection with incremental facilities governed by New York and other non-EEA laws, lenders may ask that the provisions be added. However, that may not always be possible unless a lender vote sufficient to modify the relevant provisions accompanies the addition of the incremental. Similarly, an EEA financial institution that buys into an existing facility may request that contractual recognition provisions be added, but that may not be possible without a lender vote

Care should be taken to examine the specific amendment provisions of each individual credit agreement to assess whether and at what level of assent a lender vote may be needed.

The bail-in rules do provide an "impracticability" excuse for EEA financial institutions entering into contracts that contain no bail-in recognition provision, but as of the date of this *Client Alert*, bank regulators in the individual EU member states have yet to offer guidance as to the scope and contours of the impracticability excuse or how it will be applied.

Why Is the EU Requiring "Contractual Recognition" of the Bail-In Powers in Contracts Governed by the Laws of Non-EEA Countries?

If an agreement is governed by the laws of a jurisdiction in a non-EEA country, there is a risk that a court in that jurisdiction may challenge or disregard the application of the bail-in powers of the EEA financial institution's home country resolution authority. Accordingly, EEA financial institutions are required to include in their non-EU law-governed contracts so-called "contractual recognition" clauses to reduce this risk with respect to an EEA financial institution's covered liabilities.

"EEA" Countries – Whose Banking Regulators Have "Bail-In" Powers?

As of the date of writing, the bail-in rules are already in effect for EU member state financial institutions: Austria, Belgium, Bulgaria, Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the UK.

Iceland, Liechtenstein and Norway, although not "EU" member states, are within the EEA and are required to enact national implementing legislation by the end of 2016.

Note that since Switzerland is not an EU member state, financial institutions organized under the laws of Switzerland are not subject to direct regulations under the bail-in rules, although their EEA subsidiaries may be within scope as described in clause (a) of the following paragraph.

Application to Branches and Affiliates

Under the bail-in rules, an EEA financial institution includes "(a) any credit institution or investment firm established in any EEA Member Country [that] is subject to the supervision of an EEA Resolution Authority, (b) any entity established in an EEA Member Country [that] is a parent of an institution described in clause (a) of this definition, or (c) any financial institution established in an EEA Member Country [that] is a subsidiary of an institution described in clauses (a) or (b) of this definition and is subject to consolidated supervision with its parent."

In short:

- EEA financial institutions and their US branches fall within the scope of the regulations.
- US subsidiaries of EEA firms do not fall within the scope of the regulations.
- European branches of US banks do not fall within the scope of the regulations.

Secured Facilities Not Excluded

While some loan market participants have assumed compliance would be unnecessary for senior secured transactions, the regulation will often also apply to documentation for senior secured credit facilities as well as unsecured transactions, as the obligations of the borrower may be undersecured and lender/agent obligations are generally unsecured.

What Types of Liabilities Are Excluded?

Certain categories of liabilities are explicitly excluded from the bail-in powers' scope and therefore not mandatorily subject to "contractual recognition" in non-EEA jurisdictions. Some of these categories of excluded liabilities include: fully secured liabilities, EU insured deposits, certain liabilities owed to suppliers of goods or services, and certain liabilities to employees — none of which are likely to act to exclude the obligations of financial institutions party to lending transactions.

LMA Documentation

The Loan Market Association has also published model bail-in provisions, for use in contracts governed by the laws of non-EEA jurisdictions other than the US.

The scope of this note is limited to transactions governed by the laws of jurisdictions within the US.

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