7 December 2016

BREXIT BRIEFING: ENGLISH LAW FUNDING FOR EUROPEAN BANKS IN FOCUS AS BES CREDITORS LEFT BEHIND… AGAIN

By Edward Downer, Peter Declercq, and Sonya Van de Graaff

The Court of Appeal[1] has upheld the validity of Banco de Portugal's exercise of its resolution powers, overturning last year's decision of the High Court

The Facts

Readers familiar with this case will recall that a matter of weeks after a group of investors provided over US$ 784m emergency liquidity (the **Oak Loan**) to Banco Espírito Santo (BES), it collapsed. Banco de Portugal formed Novo Banco as the good bank to which to transfer BES's 'good' assets and liabilities, leaving the 'bad' assets and liabilities behind in BES as the bad bank. As part of this process, Banco de Portugal decided to transfer the Oak Loan to Novo Banco, though it caveated this decision as being 'preliminary'. That was in August 2014. Come December that year, a further decision by Banco de Portugal reversed the decision, stating that, on further analysis, the Oak Loan '*was not transferred to Novo Banco*' and that this was effective as from the August decision.

The case in short

The claims of BES creditors which were thought to have transferred with the creation of BES good bank: Novo Banco (by a decision of Banco de Portugal in August 2014) were taken to have been left behind (and never transferred) by a subsequent decision of Banco de Portugal in December 2014. A High Court decision from August 2015 seemed, a second time, to shift those creditors' claims to Novo Banco, but the Court of Appeal's decision has held that the creditors' claims are left with BES.

[1] *Guardians of New Zealand Superannuation Fund (and others) v. Novo Banco, S.A. v. Banco de Portugal* [2016] EWCA Civ 1092. For MoFo's alert on Banco de Portugal's re-transfer of five Portuguese law bonds from Novo Banco back to BES, see https://media2.mofo.com/documents/160201eubankresolutionlaw.pdf.

The Oak Loan was provided under an English law facility agreement subject to English court jurisdiction, and, thus, absent 'supra national' law binding on the UK, the Oak Loan could not be affected by the Portuguese decisions. As Lord Justice Moore-Bick noted: '[*It] was therefore common ground that the obligations to which [the Oak Loan] gave rise were governed by English law and, in accordance with the view traditionally taken by the common law, are unaffected by foreign legislation.*'

Next steps for the BES creditors

We understand that the creditors will seek permission to appeal to the UK Supreme Court. Permission is granted only where the appeal raises an arguable point of law of general public importance. (Query if Novo Banco will argue that the decision will only have short-term ramifications due to Brexit.) If permission is not granted then the UK court process is concluded.

The creditors have however commenced proceedings to review the decision of the Banco de Portugal in the Portuguese administrative court which has power to annul the December decision.

In the context of European banks and credit institutions such as BES, restructuring powers were, at the relevant time[2], given to the home Member State resolution authority for that bank or credit institution under the European Union **Reorganisation Directive**[3] and the **EBRRD**[4]. By the time the decision came to the English court for determination, those directives had been given effect by domestic legislation in the UK.

The High Court decision

At first instance before the High Court, the creditors were held to have the better argument on the position taken by them that the December decision was not a proper exercise of a resolution power under the EBRRD by Banco de Portugal (as BES's resolution authority) since it did not satisfy the requirements of the EBRRD for a transfer back to BES. It was on this basis that the High Court held that the December decision had no impact, as a matter of English law, on the effect of the August decision to transfer the Oak Loan to Novo Banco[5].

The Court of Appeal approach – application of the EBRRD

The Court of Appeal took a different approach. It reasoned that, once the threshold question of whether the home Member State had invoked a resolution tool under the EBRRD was settled[6], its exercise of the resolution tool would (in accordance with Article 117) be brought within the definition of 'reorganisation measure' in Article 2 of the

[2] These powers have recently been conferred on the Single Resolution Board – see below.
[3] Directive 2001/24/EC as incorporated into Portuguese law. The Reorganisation Directive concerns the reorganisation and winding up of credit institutions and is also referred to as "CIWUD".
[4] Directive 2014/59/EU. Measures taken by home Member States' resolution authorities under the EBRRD will automatically be recognised throughout the Member States.
[5] At para 27. (At the first instance hearing, none of the parties invoked the Reorganisation Directive.)
[6] At para 26 Moor Bick LJ briefly addressed this point, by noting that it was 'common ground that the August decision, involving as it did, the establishment of a bridge bank, Novo Banco, to which some of the assets and liabilities of BES were transferred, involved the application of one of the resolution tools and must therefore be recognised and given effect by the English courts as a reorganisation measure'.

Reorganisation Directive and thus be granted mutual recognition amongst the Member States[7]. Specifically as regards the effect of the December decision on the August decision, the Court of Appeal said:

> 'the English courts are obliged under the directives... to give it the same effect as it had under Portuguese law ***at the date when the issue arose***. In other words, they are bound to accept that it was not effective to transfer the Oak liability to Novo Banco. It follows, in my view, that it is unnecessary and inappropriate to ask whether the December decision was a resolution measure within the meaning of the EBRRD...'[8] (emphasis added)[9]

Moore-Bick LJ said the 'chronological'[10] approach of the High Court judge in considering first the effect of the August decision and then, as a second question, the effect of the December decision was:

> '...no doubt correct, as far as it goes... but it fails to take account of the fact that the obligation to recognize the August decision involves giving it the effect that it had in Portuguese law ***at the date when the respondents commenced these proceedings***.'[11] (emphasis added)

On the evidence, the Court of Appeal accepted the trial judge's findings of the foreign law evidence that the December decision (including as regards its retrospective application) was binding and effective as a matter of Portuguese law[12].

Applying the reasoning to the facts of this case - in particular, that the issue came for determination before the English court after the December decision was made - the Court of Appeal held that the Oak Loan must be regarded as remaining with BES, since, by then, that was its effect under Portuguese law.

The Court of Appeal approach – application of the Reorganisation Directive

Given the Court of Appeal's decision, it was therefore unnecessary for it to go on and consider whether to give permission to amend the grounds of appeal that the December decision was a reorganisation measure within the meaning of the Reorganisation Directive regardless of whether it was properly to be characterised as an exercise of a resolution tool within the meaning of the EBRRD. However, the Court of Appeal did grant permission to amend and went onto hold that:

---

[7] At Para 25.
[8] Paras 28 and 29.
[9] The court relied in particular on Article 3 of the Reorganisation Directive (which provides that '*(…) the home Member State* [i.e. Portugal] *shall alone be empowered to decide on the implementation of one or more reorganisation measures in a credit institution (…)*' and '*the reorganisation measures shall be applied in accordance with the laws (…) in the home Member State* [i.e. Portuguese law]. *The reorganisation measures shall be fully effective in accordance with the legislation of that Member State through the Community: without any further formalities, including as against third parties in other Member Stats [such as the UK], even where the rules of the host Member State applicable to them do not provide for such measures or make their implementation subject to conditions which are not fulfilled.*'
[10] At Para 18.
[11] At Para 27.
[12] At paras 16 and 17(b).

> '(...) The December decision purported to clarify the effect of the August decision and was therefore very closely connected to it. In those circumstances ***I think the December decision is to be regarded as, or as part of, a reorganisation measure*** and is entitled to universal recognition under the Reorganisation Directive. In my view, to hold otherwise would undermine the scheme of universal recognition of measures taken by the home Member State to deal with failing financial institutions which is fundamental to the scheme of European law in this field.'[13] (emphasis added)

Take-aways from the Court of Appeal judgment

The effectiveness of a decision/s of the home Member State made under the EBRRD will be examined by reference to the effect it has/they had under the law of the home Member State as at the time that the decision/s come for determination by the English court.

Thus, it might be said that the Court of Appeal has taken a more purposive or liberal approach to measures falling within the directives than the High Court's more technical approach. **European bank resolution law has since changed**

Since the collapse of BES, the Single Resolution Mechanism[14] has come into effect. As of 1 January 2016 resolution tools under the EBRRD are exercised, not by the home Member State resolution authority, but by the Single Resolution Board (**SRB**)[15] for systemically important banking groups supervised by the European Central Bank. Further, the SRB has control of the Single Resolution Fund, a fund financed by the banking sector and able to be used to assist failing groups. (Note that the Bank of England is exempt from this change, and it has sole authority to exercise resolution powers in respect of UK banks and credit institutions, whether or not systemically important.)[16]

How the decision impacts restructuring and capital markets transactions

Consider the situation of troubled Italian bank Banca Monte dei Paschi di Siena (**Banca MPS**), the oldest surviving bank in the world.

There is a great deal of speculation about how Banca MPS's troubles will be resolved in the short and medium term. Recent market speculation has focused on a consensual solution that will not require resolution tools to be used under the EBRRD or reorganisation measures under the Reorganisation Directive. If resolution tools are required, though, the SRB will determine how they are used rather than the Banca d'Italia, the Italian resolution authority.

[13] At Para 34.
[14] Regulation 806/2014
[15] Members are the Chair (currently an appointee from Germany), four of the Board Members (currently comprising appointees from Finland, Spain, Italy, Netherlands, France), an appointed representative of the relevant national resolution authority (where the resolution decision relates to a company/group from one state), and an appointed representative of the group-level resolution authority together with that of the relevant national resolution authority in which a subsidiary/supervised entity is established (where decision relates to cross-border group). The voting members are the Chair and the four Board Members only, though consensus is sought to be achieved.
[16] There has been no change to the EU-wide recognition of resolution tools, including in the UK.

At 31 December 2015, Banca MPS had issued total debt securities of almost €29.4 billion, much of which appears to have been issued under a €50 billion debt issuance programme that is subject to English law.

Creditors of Banca MPS today have clarity from the Court of Appeal's decision that any resolution measure and related implementation or application decisions or decisions 'closely connected'[17] and recognised as lawful and binding under Italian law (which would be made by the SRB) will automatically be recognised and so affect contracts subject to English law. The English court will not scrutinise, under the lens of English law, those measures.

However the position of creditors in the future is clouded by the result of the 23 June 2016 referendum that the UK should leave the EU.

What impact will Brexit have?

Bearing in mind that (absent relevant 'supra national' legislation) foreign legislation does not affect English law obligations, the consequence of Brexit on European bank resolution measures becomes uncertain for investors of debt issued by EU Member State banks. Immediately after Brexit, the UK will be at liberty to repeal domestic legislation that gives effect to the Reorganisation Directive and the EBRRD. Whether the UK does in fact repeal them is a matter of conjecture.

Insofar as the future of bank resolution tools is concerned, article 55 of the EBRRD uniquely requires (through domestic law from 1 January 2016) EU Member State banks to include a clause recognising the significant impacts that the resolution tools may have on contracts creating liabilities that are governed by a law of a non-EU Member State.

Brexit takeaway
Today there is a complex web of European legislation that forms part of English law. Once Britain leaves the EU, Article 55 of the EBRRD will require contractual recognition of European bank resolution tools in debt securities governed by English law issued by European banks. That law does not apply until Brexit happens.

At that time, European legislation becomes foreign legislation. English courts will not, adopting the traditional common law view, have regard to the impact of European legislation (including the EBRRD) on contracts governed by English law.

After Brexit, market participants can expect this to become commonplace in English law-governed debt securities issued by European banks. But until Brexit, there will be a substantial number of English law debt securities issued by EU Member State banks that do not include a contractual recognition of EU bank resolution measures.

Recent debt issuances have simply included a Brexit risk factor to the following effect:

> 'In addition, Brexit could lead to legal uncertainty and potentially divergent national laws and regulations as the United Kingdom determines which European Union laws

[17] See footnote 13.

> to replace or replicate. Any of these effects of Brexit, and others the Group cannot anticipate, could adversely affect the Group's business, results of operations, financial condition and cash flows, and could negatively impact the value of the Notes.'[18]

If Brexit negotiations do not result in the UK continuing the legislation that automatically recognises EU Member State resolution tools, then market participants are left to ponder how English courts will approach the impact of European bank resolution tools once European legislation transitions to its new status as legislation foreign to the UK. It may result in resolution measures having no effect on English law-governed debt securities. For the sake of certainty, market participants may in the meantime see the benefit of including an Article 55 clause in these securities.

Conclusion

As this case has shown, the English law jurisprudence is still developing and, with Brexit looming, may never have a chance fully to mature. However, until Brexit, this case is an opportunity for the Supreme Court to provide some much-needed certainty on the scope of the SRB's power to amend creditors' English law instruments issued by troubled non-UK banks and credit institutions.[19] In addition, it is an opportunity for it to provide further guidance on the interaction between the Reorganisation Directive and the EBRRD. On the face of the guidance provided by the Court of Appeal in this decision, the Reorganisation Directive (and in particular the construction of the term 'reorganisation measure') seems to be so broad as to make the EBRRD redundant for the purpose of universal recognition.

Contact:

Edward Downer	**Peter Declercq**	**Sonya L. Van de Graaff**
44 (207) 9204007	44 (207) 9204041	44 (207) 9204039
edowner@mofo.com	pdeclercq@mofo.com	svandegraaff@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for 13 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. Visit us at www.mofo.com.

[18] Société Générale prospectus for Issue of USD 1,500,000,000 Undated Deeply Subordinated Resettable Interest Rate Notes dated 7 September 2016.
[19] As at the date of this alert, leave to appeal to the Supreme Court has been sought.