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BRRD: Contractual Recognition of Bail-in and Resolution Stays

The EU Bank Recovery and Resolution Directive gives resolution authorities in Europe wide-ranging powers to manage failing financial institutions. These include powers to write down debts owed to creditors, convert debt to equity or impose temporary stays on termination rights. Cross-border recognition of such powers is built into the European legislative framework. However, there is no international law for the recognition of the exercise of foreign governmental powers. Various legislative measures and regulatory steps have been taken to address this potential impediment to the resolution of a regulated entity, including requiring regulated entities to provide for a clause in non-EU law governed contracts by which their creditors agree to and recognize the bail-in or temporary stay powers of the relevant resolution authority. This memorandum considers the practical and legal implications of bail-in and stay clauses for regulated entities, their contractual counterparties, clients and buy-side participants.

Introduction

Under the EU Bank Recovery and Resolution Directive ("BRRD") resolution authorities have the power, among other things, to: (i) write down or convert into equity certain liabilities of the firm in resolution ("Bail-In"); and (ii) impose temporary restrictions on early termination rights on the firm's counterparties ("Resolution Stays"). Resolution steps under BRRD are given cross-border recognition throughout the EU. As a result, resolution steps under BRRD with regard to contracts governed by the laws of an EU Member State should be construed as valid administrative acts. However, in the case of contracts which are governed by the laws of a third-country (i.e. non-EU law governed contracts), there is a risk that the effectiveness of a Bail-In or Resolution Stay may be challenged under the law of the contract. For example, under a contract governed by New York law, a creditor might argue in the US courts that a conversion to equity was not agreed to under the contract and that the EU bank is in default of a payment obligation, notwithstanding the resolution action.

To remove this potential obstacle to resolution, the Financial Stability Board ("FSB") recently re-affirmed the importance of contractual clauses that recognize the effectiveness of resolution actions taken in the jurisdiction in which the firm is established.[1] The rationale behind these recognition clauses is that counterparties are less likely successfully to challenge the effectiveness of resolution actions if they contractually agree to be subject to such actions.

Although bail-in clauses and stay clauses pursue a similar objective, BRRD only includes a requirement for parties to third country law governed contracts to agree to bail-in clauses. By contrast, in the absence of a harmonized European approach, the regulatory regime applicable to the contractual recognition of Resolution

[1] FSB Principles for Cross-border Effectiveness of Resolution Actions, 3 November 2015.

Stays is driven by national initiatives. This memorandum[2] considers the EU bail-in regime and some of the initiatives coming out of EU Member States on contractual stays, including the UK and Germany.

Bail-In

Effective 1 January 2016, firms subject to BRRD have been required to include in their non-EU law governed contracts a clause by which "a creditor or party to the agreement" recognizes and agrees that liabilities may become subject to bail-in (the "Bail-in Requirement"). The scope of the Bail-in Requirement is very broad. There is no materiality threshold. Beyond certain limited exceptions, it appears to be triggered by any type of liability. The UK implementation of BRRD captures not only the firms' debt but also other liabilities, irrespective of whether the liability is "present or future, certain or contingent, ascertained or sounding only in damages."[3]

Scope

The Bail-in Requirement applies to EU incorporated banks and large investment firms, their EU incorporated holding companies and their EU subsidiaries. This includes non-EU branches of EU incorporated firms but excludes non-EU incorporated firms or their EU branches.[4] We refer to these entities in this note as "Relevant Firms".

Limited Exceptions

There are limited exceptions to the Bail-in Requirement. A resolution authority may decide to exclude from the Bail-in Requirement liabilities that may be bailed-in under the law of the third country or under a binding agreement with that country. However, these exclusions must be determined by the resolution authorities and they are not expected to become available any time soon.

Further liabilities are excluded as a matter of law. These are:

- Secured liabilities;
- Client money and fiduciary relationships;
- Liabilities to other banks and investment firms with an original maturity of less than 7 days, excluding liabilities to members of the same group;
- Liabilities with a remaining maturity of less than 7 days, owed to designated payment and settlement systems or their participants, which liabilities arise out of the firm's participation in such a system;
- Deposits covered by a deposit guarantee scheme;
- Deposits from a natural person or small or medium-sized enterprise, including those made through non-EU branches of EU firms;

[2] You may like to refer to our other client notes on aspects of the BRRD: "Bank Resolution: English and German Courts Place Limits on Obligations to Give Effect to Actions of Resolution Authorities in Other Member States," available here, "Bank Recovery & Resolution Directive: Implications for Repo and Derivative Counterparties" available here and "UK Regulatory Proposals on Removing Impediments to Resolvability," available here.

[3] See the definition of liability as set out in the PRA's Rulebook on Contractual Recognition of Bail-in, available here.

[4] National implementation rules must also be considered because local definitions might differ based on the interpretation of in-scope entities by Member States.

- Liabilities for contributions to a deposit guarantee scheme;
- Liabilities to employees such as accrued salary, pension benefits, fixed remuneration or variable remuneration that is regulated by a collective bargaining agreement but not for any variable remuneration of a material risk taker;
- Preferred liabilities owed to any tax or social security authorities; and
- Liabilities to any commercial or trade creditor for the provision of goods or services that are "critical to the daily functioning of its operations," including IT services, utilities, and rental, servicing and upkeep of premises.

Liabilities resulting from client money and fiduciary relationships are excluded from the Bail-in Requirement, but only if the client money or fiduciary relationship is protected under applicable insolvency law. As the client money and fiduciary relationship protections afforded by national insolvency regimes of EU Member States vary significantly, there is no "one fits all" approach for European firms.

The exclusion for liabilities to employees is fairly restricted and employee contracts will often fall outside of the exclusion, particularly if the employer has other obligations under the contract such as confidentiality obligations. Relevant Firms are experiencing difficulties in interpreting the exclusion and some are adding bail-in clauses to all of their employee contracts.

The exclusion available for liabilities owed to designated payment and settlement systems or their participants is limited to short-term settlement contracts, which means that most derivatives that are cleared do not fall within the exclusion. Derivatives central counterparties ("CCPs") must therefore rely on the secured liabilities exclusion.

The exemption for secured liabilities is the most useful one in practice. If a Relevant Firm is asked to provide security for any actual or potential liabilities there would no longer be a need for a bail-in clause to be included in any contract governed by a non-EU law and the mandatory application to EU law governed contracts would be mitigated from the perspective of the creditor.

Arguably that is the right result for the creditor who might otherwise be bailed in (such as a trustee claiming under an indemnity) or bear the consequences of a bail-in (such as a syndicate member who needs to pick up the cost of an *pro rata* share of an indemnity to an agent not paid by another lender who is bailing in indemnity claims) as those sort of claims are not otherwise in the position to price and be compensated for bearing clear bail-in risk. It remains to be seen what the impact will be on the extent of collateral that may be required of Relevant Firms by their counterparties seeking to negate bail-in risk.

However, according to the draft European Banking Authority ("EBA") technical standards, almost any secured liability has the potential to become unsecured due to a shortfall in the value of the security. To qualify for the secured liability exception, a liability must not only be fully secured on creation but also be governed by contractual terms that ensure full collateralization on a continuous basis in compliance with regulatory requirements.[5] Also, each contract must be screened on a liability-by-liability basis. Even where some liabilities

[5] In the context of the Bail-in Requirement and the secured liability-exception, it is not entirely clear what is meant by "in compliance with regulatory requirements."

are secured, it must be checked whether the contract might also give rise to liabilities which fall outside the scope of the security purpose and therefore trigger the need for a bail-in clause.

Due to the EBA's limited mandate in the law-making process, the draft technical standards issued by the EBA do not expand upon the limited exceptions already included in BRRD. In many situations, it is unlikely that the exceptions to the Bail-in Requirement will give sufficient comfort to Relevant Firms for them to refrain from including a bail-in clause.

There appears to be an underlying assumption by the EU authorities that counterparties to Relevant Firms will accept that in-scope liabilities will become subject to bail-in without altering their terms of business to either avoid the additional risk or be compensated for taking that risk. This may reflect that bail-in is a regarded a matter of law rather than something which EU banks are able to negotiate.

Breadth of the Term "Liability"

The Bail-in Requirement extends to any contractual liability of the Relevant Firm. It is not limited to liabilities qualifying as total loss absorbing capital ("TLAC") or minimum requirements for own funds and eligible liabilities ("MREL"). Neither the likelihood of a Bail-In nor any of the "exceptional circumstances" specified in the BRRD affect the scope of the Bail-in Requirement. It might even capture liabilities that, due to their uncertain nature, are not recorded as liabilities on the balance sheet and are expected to have very little or no loss-absorbing capacity. In the context of loan documentation, the Loan Market Association ("LMA") has identified the following examples of in-scope liabilities:

- lending commitments;
- indemnities given to the facility agent, security agent and issuing bank;
- requirements to share or turn over recoveries made from the borrower;
- confidentiality obligations;
- requirement to obtain borrower consent / consultation prior to transfer;
- restrictions on a creditor's actions typically found in inter-creditor documentation;
- administrative obligations, such as notifications of tax status or requirements to make other notifications or to supply or forward information; and
- potential non-contractual liability under loan documentation such as potential claims in negligence or misrepresentation.

While banks acting as finance parties under a syndicated facility agreement clearly have payment obligations towards the borrower and other finance parties which fall within scope, the situation is less clear where a contract does not expressly provide for monetary obligations of the Relevant Firm. A confidentiality agreement is therefore an interesting inclusion in this list. This is a contractual duty which, if breached, would give rise to a damages claim by a bank's counterparty, rendering that party a creditor. Even though the (non) existence of any such liability is within the control of the bank, this is thought to trigger the Bail-in Requirement. A similar analysis applies to any contract that includes a warranty or representation on the part of the EU bank. Of course, one could argue that theoretically any duty assumed by the firm could transform into a monetary obligation "sounding in damages" in the event of a breach of contract. It is questionable whether the Bail-in

Requirement should be construed that broadly, but those who must comply with the Bail-in Requirement are to date adopting a conservative approach to compliance.

Strict Transitional Regime

Strictly speaking, the Bail-in Requirement has no retrospective effect. It is triggered by certain events occurring on or after the trigger date specified in the national implementing legislation. BRRD requires this to be no later than 1 January 2016. While some EU Member States (e.g. the UK and Germany) started to phase in the Bail-in Requirement in 2015, most national legislators specified 1 January 2016 as the trigger date.

As to the relevant events, BRRD simply refers to "liabilities issued or entered into after" the trigger date. However, the more detailed draft technical standards of EBA clarify that the Bail-in Requirement extend to:

- pre-existing liabilities which become subject to a material amendment[6] after the trigger date;
- liabilities which are created after the trigger date under agreements entered into before the trigger date (e.g. pre-existing framework or master agreements);[7]
- liabilities issued under debt securities issued after the trigger date; and
- liabilities under debt securities issued before or after the trigger date under agreements entered into before that date that are subject to material amendment.

Relevant Firms might therefore be required to re-negotiate pre-existing documentation in some circumstances. By way of example, the LMA takes the view that the Bail-in Requirement applies to loan transfers that complete on or after the trigger date regardless of the date of the underlying facility agreement or the date of any applicable secondary debt trade. Under this interpretation, a bank that transfers into a pre-existing facility agreement after 1 January 2016 would only be entitled to do so if all other parties agree to a bail-in clause.

Relevant Firms will therefore have to engage in a remediation exercise to ensure that all relevant existing and future agreements under which liabilities may arise contain a bail-in clause and put controls in place to ensure that going forward all relevant documentation is BRRD compliant. Agreements will have to be identified and filtered based on whether they are governed by non-EU law, whether any in-scope entity is a party to the agreement, whether they provide for material amendments to pre-existing contracts and whether a liability which does not benefit from an exception has arisen or may arise under the agreement.

In the UK, both the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority have published a "waiver by consent" which would allow a Relevant Firm to delay the application of the Bail-in Requirement to phase 2 liabilities (i.e. liabilities other than unsecured debt instruments and regulatory capital instruments)[8] until 30 June 2016 where compliance with the Bail-in Requirement is "impracticable." The approach adopted by the PRA and FCA is based on the practical issues experienced by Relevant Firms when seeking to include a bail-in

6 Non-material amendments are those that do not affect the substantive rights and obligations of the parties. By way of example, the EBA refers, inter alia, to automatic adjustments of interest rates and changes to signatory details.

7 According to the draft technical standards of the EBA, netting sets that include liabilities pre-dating the trigger date and liabilities created on or after the trigger date, must either be split or both sets will be subject to the bail-in clause.

8 The PRA phased in its Bail-in Requirement so that it was applicable to unsecured debt instruments, additional Tier 1 instruments and Tier 2 instruments from 19 February 2015 and to all other relevant liabilities from 1 January 2016.

clause in existing agreements which, in most cases, prompts re-negotiation with counterparties. However, the PRA will not allow a delay if implementation of a bail-in clause is merely inconvenient. This distinction between something impracticable and "inconvenient" is rarely clear cut, but most UK Relevant Firms have applied for and been granted this waiver. The PRA are expected to propose more permanent amendments to their rules on the Bail-in Requirement.

In some situations, additional guidance from resolution authorities and supervisors might be required to allow for practicable solutions. Although the main features of the Bail-in Requirement are locked in by the text of BRRD, the UK approach shows that some flexibility regarding the enforcement of the Bail-in Requirement may be available at national level. Changes to the Bail-in Requirement may also become available upon review of BRRD in the context of MREL. As part of the revision it should be considered whether the Bail-in Requirement can be cut back in connection with a potential broadening of exemptions from bail-in more generally. In particular, the inclusion of obligations of non-secured bits of secured arrangements, derivatives and more generally, CCPs within the scope of bail-in has been widely criticised as potentially creating systemic risk.

Consequences of a Breach

If a Relevant Firm fails to include a bail-in clause in an in-scope contract it will be in breach of national laws implementing BRRD and could therefore be fined or censured. However, this will not prevent the resolution authority from bailing in the liability. Inclusion of a bail-in clause ensures that a counterparty would be able to participate in any conversion to equity and therefore may get some recovery on the debt. It is likely that a resolution authority would bail in all unsecured debt and only leave secured creditors unaffected, regardless of whether the clause exists. As a result, the only obvious downside of including a bail-in clause (in a conversion to equity scenario) is that a counterparty would be giving up rights it might otherwise have under the non-EU governing law of the contract to contest the effect of resolution action taken in the EU in relation to the relevant EU firm.

The consequences of breaching the Bail-in Requirements depend on the national regime. It is generally expected that even without a bail-in clause the contract will remain valid and enforceable.

Non-compliance with the Bail-in Requirement could ultimately result in the competent authority forming the view that there is an impediment to the Relevant Firm's resolvability. In this context, resolution authorities might require Relevant Firms to provide legal opinions on the enforceability and effectiveness of bail-in clauses. It is not clear yet if, and under what circumstances, resolution authorities across Europe will make such requests. It is also not clear if the opinion would be required for each contract, each type of transaction or only in relation to each relevant non-EU jurisdiction. It remains to be seen if bail-in clauses will also be considered in the transaction opinions issued by external counsel. Current market practice for transaction opinions is to carve out bail-in clauses and to include qualifications as to the effect of resolution powers.

Forms of Bail-In Clauses

The EBA has published draft technical standards[9] setting out the minimum components of a bail-in clause. Those components are:

[9] EBA/RTS/2015/06 "Final Report — Draft Regulatory Technical Standards on the contractual recognition of write-down and conversion powers under Article 55(3) of Directive 2014/59/EU," available here.

1. Acknowledgement and acceptance by the counterparty that:
   a. The liability may be subject to bail-in;
   b. It is bound by the effects of a bail-in, including any reduction in the principal or outstanding amount due (includes accrued but unpaid interest) or any conversion of the liability into ordinary shares or other instrument of ownership;
   c. The terms of the agreement may be varied as necessary to give effect to the exercise of the bail-in powers of the resolution authority and any such changes are binding on it;
   d. Ordinary shares or other instruments of ownership may be issued to or conferred on the counterparty as a result of the bail-in; and
   e. The clause is exhaustive as to the exclusion of other agreements, arrangements or understandings between the counterparties relating to the subject of bail-in.
2. A description of the bail-in powers of each resolution authority as transposed by the relevant Member State.[10]

Various industry associations have published, or are currently working on, standard terms to satisfy the Bail-in Requirement. In addition to the below, the International Swaps and Derivatives Association is also said to be working on a protocol addressing the Bail-in Requirement.

1. The Association for Financial Markets in Europe ("AFME") published the "Model clause for the contractual recognition of bail-in under Article 55 BRRD" for use by issuers of debt securities organized in the UK but which are governed by NY law.[11] AFME is currently developing additional forms for the purposes of capital market transactions (e.g., forms aimed at other types of issuers and other types of liabilities).
2. The International Capital Markets Association ("ICMA") included bail-in terms in its Agreement Among Managers which forms part of the ICMA Primary Market Handbook.[12]
3. The LMA[13] and the Loan Syndications and Trading Association ("LSTA")[14] published recommended forms of bail-in clauses for European and US style loan documentation.

Various relevant EU firms have formed their own bespoke forms of a bail-in clause. Despites these efforts and the draft technical standards issued by the EBA, Relevant Firms are still struggling to fully understand the implications for their existing and new businesses — as are their clients and the buy-side. A plethora of different forms of a bail-in clause abound. Some clauses restrict the scope of the provision to liabilities "except to the extent secured" whilst others do not. In our view, it is advisable to include this exception to ensure that any powers which prejudice counterparties going beyond BBRD are recognised contractually. Given the breadth of the term "liability," the limited exceptions and the strict transitional regime, it is not surprising that Relevant

10 Due to differences in local BRRD implementation, a bail-in clause might need to be tailored to the specific rules of the relevant jurisdiction.

11 The AFME model clause is available here.

12 The ICMA Primary Market Handbook is available here. Access is only available with a subscription.

13 The LMA guidance is available here.

14 Further information on the LSTA template is available here.

Firms tend to include bail-in clauses in almost every contract governed by a third-country law. We have also seen some Relevant Firms attempting to negotiate a new governing law (e.g. English law) into non-EU law governed contracts. This approach has the potential to adversely affect legal opinions, the validity of jurisdiction clauses and the robustness of boilerplate contractual provisions. However, it does avoid the need for a bail-in clause.

Resolution Stays

Contrary to the approach adopted for bail-in, there is no BRRD requirement for clauses recognising suspension or disapplication of contractual termination rights (so-called "stays") to be included in contracts governed by the law of a third-country. Some EU Member States have committed to introduce regulations imposing contractual recognition of Resolution Stays (the "Contractual Stay Requirement"). However, these initiatives do not derive from European legislation. Instead, they are part of the coordinated effort of member countries of the FSB to improve cross-border recognition by imposing contractual solutions. Accordingly, the introduction of the Contractual Stay Requirement in Europe does not follow a harmonized approach. This means that the national regimes are likely to take effect on different dates and may differ in terms of which entities are in scope and the type of contracts that are caught.

A further initiative has been taking place through the International Swaps and Derivatives Association ("ISDA"). The ISDA 2015 Universal Resolution Stay Protocol[15] has been adhered to by most major banks following regulatory requests to do so, but remains little used by the buy-side, corporates and other counterparties. It is expected that the buy-side generally will not adhere to this protocol, but instead to the ISDA Resolution Stay Jurisdictional Modular Protocol, which is expected to be published later this year.[16]

The UK Contractual Stay Requirement

The PRA published its final rules on contractual recognition of Resolution Stays in November 2015.[17] The rules prohibit certain firms from creating new obligations or materially altering an existing obligation under a financial contract governed by the law of a non-EEA jurisdiction unless the counterparty agrees in an "enforceable manner" that it will only be able to exercise its right to terminate the contract or enforce a security interest to the extent that it would be able to do so under the UK's Special Resolution Regime if the contract were subject to English law. Non-material amendments include changes that occur automatically under the contract without the need for any subsequent agreement by the parties and administrative changes such as changes to notification or business day conventions. The PRA has confirmed that legal opinions are not required as a matter of course but Relevant Firms must be able to demonstrate to the PRA, if so requested, that the contractual clause is enforceable.

15 The 2015 Protocol is similar to the 2014 ISDA Resolution Stay Protocol. However, the 2015 Protocol includes an annex that expands the 2015 Protocol to cover certain securities finance master agreements, including securities financing transactions and repurchase transactions.

16 Further information about the ISDA Protocols is available here.

17 See PRA Policy Statement PS25/15: Contractual Stays in Financial Contracts Governed by Third-Country Law, 13 November 2015, available here; PRA Supervisory Statement SS42/15 Contractual Stays in Financial Contracts Governed by Third-Country Law, 13 November 2015, available here.

The rules will apply to UK banks, building societies and larger investment firms (i.e. those designated by the PRA), their financial holding companies and mixed financial holding companies. The rules will also apply to credit institutions, investment firms and financial institutions that are subsidiaries of any such firms or their parent entities, regardless of their location, where a guarantee exists from the in-scope firm.

The UK rules will be phased in and will be effective from:

- 1 June 2016 for financial arrangements with counterparties that are credit institutions or investment firms or an entity that would be an investment firm if it were headquartered in the EU; and
- 1 January 2017 for financial arrangements with all other counterparties.

The German Contractual Stay Requirement

German banks, investment firms and their respective group companies are already required to include a stay clause in their "non-European" financial contracts. This can be done either by adherence to a resolution stay protocol or by agreement to a specific clause by which the counterparty recognises and agrees to be bound by any suspension of termination rights in accordance with the German implementation of BRRD ("SAG"). The German Contractual Stay Requirement came into force on 6 November 2015, but the obligation will not cover financial contracts entered into prior to 1 January 2016 unless liabilities arising from financial contracts entered into prior to that date are subject to a netting agreement that also covers liabilities incurred after 1 January 2016.

As there are currently no specific buy-side resolution protocols or finalized buy-side adherence techniques to the existing protocol for G-SIBs, the German resolution authority, the Federal Agency for Financial Market Stabilisation ("FMSA"), is expected to liaise with German firms about compliance with the German Contractual Stay Requirement, in particular with regard to non G-SIBs. The FMSA is generally entitled to enforce the German Contractual Stay Requirement as of the beginning of the year. The SAG, however, expressly provides that it may, at its discretion, consider a number of circumstances, in particular the business model, the affected foreign market, the contract type, the systemic relevance as well as the expected impact on the resolvability of the institution.

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