A new regime for bank crisis management

Louise Verrill and Paul Durban report on the recent EU Bank Recovery and Resolution Directive

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Overview

The financial crisis has thrown into sharp relief the limited scope of resolution tools to deal with failing financial institutions in Europe. Despite the fact that bank insolvency law is an important part of the European Union (**EU**) regime, the EU has faced hurdles and delays over the years in agreeing on a set of common principles. However, the number of high-profile banking failures in Europe during the financial crisis has provided clear evidence of the need for more robust crisis management arrangements and a minimum harmonisation regime for the resolution of banks in the EU.

The Directive

On 11 December 2013, the European Council and Parliament reached an agreement on the Bank Recovery and Resolution Directive (the **Directive**) establishing a common framework for the recovery and resolution of credit institutions and larger investment firms. The Directive aims to prevent systemic damage caused by the disorderly failure of financial institutions, and to align national bank recovery schemes across Europe while focusing on protecting the banking system as a whole rather than individual banks. The Directive is likely to come into force on 1 January 2015.

Scope

The Directive establishes a phased approach to supporting troubled financial institutions encompassing precautionary, early intervention and measures designed to prevent bank failures. Where failure is unavoidable, the Directive aims to ensure orderly resolution, even for banks operating across national borders.

1. Prevention

Institutions will be required to develop robust recovery plans ('living wills') at both firm and group level. These will be used by resolution authorities (likely to be the Bank of England in the UK) to construct credible resolution plans. They will be tested against a range of scenarios, and will be frequently reviewed by regulators.

2. Early intervention

Resolution authorities will have the ability to appoint a 'special manager' to restore an institution's financial condition and improve the management of its business. Special managers may act alongside or even replace existing management and are equipped with all of the management's existing powers. The special manager's powers may therefore include an increase in capital, a corporate reorganisation or a takeover by another viable institution.

3. Resolution

If certain conditions are satisfied, the resolution authority will prepare a resolution plan for the institution at both a firm and a group level identifying the most appropriate resolution tools to be used in each case.

The resolution 'tools' include:

Sale of Business Tool: This enables resolution authorities to sell all or part of the business, on commercial terms and without following certain procedural requirements, such as shareholder consent.

Bridge Institution Tool: this enables resolution authorities to transfer all or part of the business to a temporary publicly controlled entity (such as a bridge bank). The business continues to operate as a going concern. The purpose of this tool is for the business to eventually be sold back to the private sector.

Asset Separation Tool: This enables the transfer of 'bad' assets to an asset management vehicle. This tool may only be used in conjunction with another resolution tool to prevent the failing firm from benefiting from an undue competitive advantage.

Bail-in Tool: This enables resolution authorities to restructure the liabilities of a distressed institution by writing down unsecured debt or converting it to equity. It may be used where an institution is failing or about to fail, with the aim of restoring its viability. The scope of liabilities subject to the bail-in tool is broad and all liabilities of an institution are subject to bail-in, unless excluded. Excluded liabilities include secured and other collateralised liabilities (including title transfer collateral arrangements), insured deposits and liabilities to commercial or trade creditors for the provision of services.

Funding of the resolution tools

Resolution will be partly funded by national financing arrangements, to which banks and investment firms must contribute. They will pay an annual levy as a proportion of their total covered bonds. The Directive also effectively proposes an EU-wide

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resolution fund, by requiring Member States to provide cross-financing to each other where national financing arrangements are exhausted.

Impact of the bail-in tool

It is anticipated that the bail-in tool will not come into effect until 1 January 2016 but it is probably the most controversial aspect of the Directive. Its scope is broad and the purposes for which it may be used also give resolution authorities vast discretion. This may conceivably cause the tool to be used before establishing the non-viability of an institution rather than as a last resort. It is also possible that using it could be perceived by the markets as an indicator of insolvency and trigger further liquidity issues.

While most secured debt is exempt from the tool, covered bonds may be caught at the relevant member state's discretion. Claims with original maturities of less than one month are excluded. But this exclusion may in-turn incentivise very short-term funding and deter vital long-term investment.

The most contentious aspect is the tool's capacity to distort the hierarchy of creditors and shareholders via 'debt write down.' Authorities will be able to convert debt into common equity without consulting creditors and debt write down could potentially trigger compensation claims for interference with contractual or property rights. Unsecured creditors will justifiably demand higher returns on investments to guard against these risks and it remains to be seen whether markets price these fundamental changes into the costs of the capital they provide to banks.

Conclusion

By setting out common rules for a bank recovery and resolution regime, the EU wants to facilitate a more orderly and certain legal framework aimed at reducing the potential public costs of future bank failures. Whether the Directive results in a safer and more disciplined banking system will ultimately depend on how the measures are exercised (especially the bail-in tools) and whether interaction between supervisors and regulators on a national level and resolution authorities across the EU proves to be effective. ■

THE BAIL-IN TOOL IS PROBABLY THE MOST CONTROVERSIAL ASPECT OF THE DIRECTIVE

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The liability of shareholders of French companies

Delphine Caramalli and Guilhem Bremond ask what liabilities shareholders of French companies are exposed to in cases of bankruptcy

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No statutory rules on shareholders liability as such exist under French law but, in certain circumstances, French judges can hold shareholders liable should the company they invested in be liquidated as a result of a bankruptcy proceeding.

Article L. 651-2 of the French Commercial Code[1] defines the liability exposure of a *de facto* director (as well as a *de jure* director[2]) who engaged in specific acts of mismanagement resulting in an excess of liabilities over assets of the underlying company. As *de facto* directors (as well as *de jure* directors) may be individuals, legal entities[3], or individuals who serve as legal representatives of legal entities (Article L. 651-1 of the French Commercial Code), shareholders can be qualified as *de facto* directors if it is demonstrated that they acted as directors of a company.

In this context, shareholders must be cautious to limit their liability exposure in case the company they own (in whole or in part) faces financial difficulties. Although shareholders must avoid taking any action or decision that could be qualified as management acts at the company's level, they should request exhaustive information on the company's situation. They also should formulate suggestions (but not instructions) to the company's *de jure* director such as filing a formal request before the President of the Commercial Court for the opening of amicable proceedings (*mandataire ad hoc* or *conciliateur*) or appointing an independent firm to conduct business reviews and management forecasts. Written correspondences (emails) are often provided to Courts to demonstrate a *de facto* management act of a shareholder in order to hold such shareholder responsible for mismanagement. Shareholders should further limit to grant loans to the debtor company (if the latter faces serious difficulties) outside the frame of an amicable proceeding.

From a strict legal prospective, a person is deemed to act as a *de facto* director, according to relevant French *jurisprudence* (case law) and *doctrine* (scholarly opinion), if it is first demonstrated that this person performed, directly or indirectly, *affirmative acts of management*. A person cannot be designated as a *de facto* director for failures or omissions to act. In addition, it has to be demonstrated that he/she performed these acts in an *independent* manner. For instance, a person cannot be considered a