

## Looks Like Another Test Case For EU Bank Resolution Law

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Readers interested in the Banking Recovery and Resolution Directive (BRRD)[1] no doubt have been following the ongoing travails of the Portuguese "good bank" Novo Banco SA and "bad bank" Banco Espírito Santo SA (BES).[2]

The latest news hitting the headlines was on Dec. 29, 2015, when Banco de Portugal (BDP), acting as Portuguese resolution authority, announced (the "2015 resolution") that it had retransferred five Portuguese law-governed senior unsecured bonds ("affected liabilities") from Novo Banco back to BES. The retransfer occurred some 16 months after BDP had resolved to transfer the very same affected liabilities from BES to Novo Banco.

By way of reminder, Novo Banco was created as a "bridge bank" in connection with resolution powers exercised by BDP over the troubled BES in August 2014 ("2014 resolution"). As part of the 2014 resolution, the affected liabilities (along with BES' other senior ranking liabilities), were transferred from BES to Novo Banco. Novo Banco was established specifically to take over those parts of BES that BDP considered viable, so as to enable a continuation on a "business as usual basis." This would facilitate BES (now only containing the nonviable parts of the business) being wound down in an orderly manner. The holders of the affected liabilities ("holders") would no doubt have been relieved that their assets were transferred to Novo Banco.

The retransfer set out in the 2015 resolution seems to have been influenced by the litigation before an English court involving an English law-governed loan also transferred from BES to Novo Banco under the 2014 resolution.[3] The English court held that the 2014 resolution was a valid exercise by the BDP of a resolution action pursuant to the Portuguese legislation implementing the BRRD in Portugal, and as such must be recognized (pursuant to Article 66 of the BRRD) in the U.K., but the court also held that a "ruling" subsequently made by the BDP with respect to the same loan did not constitute an exercise of a

“resolution action” within the meaning of the BRRD.

The “ruling” was that a previous transfer of the English law-governed loan from BES to Novo Banco was never in fact made. The court held that since the “ruling” did not constitute the exercise of a resolution action, it did not qualify for recognition status within the scope of Article 66(6) of the BRRD. Unlike the transfer of the loan that was the subject of that English litigation, the affected liabilities in the 2015 resolution are explicitly subject to a retransfer formally authorized by a BDP board resolution. It is further interesting to note that only Portuguese law-governed bonds are the subject of the retransfer while the instrument in the English litigation was governed by English law.

On Nov. 14, 2015, BDP announced in a press release that, according to ECB Banking Supervision stress tests, Novo Banco had a shortfall of €1,398 million in the adverse stress test scenario (CET1 ratio of 2.43 percent, compared with a 5.5 percent threshold), estimated for end of 2017.[4] In a Dec. 29, 2015, press release, BDP announced that effecting the retransfer of the affected liabilities solved the shortfall for Novo Banco.

Not surprisingly, the holders are unhappy about the retransfer, since they will be faced with a liquidation value return. The resulting destruction of value is reflected in the bonds now trading in the single digits (down from (near) par value before the retransfer).

### **What Questions Should the Holders be Asking?**

Holders looking at grounds to challenge the retransfer have difficult questions with which to grapple. The BRRD grants extraordinary rights to resolution authorities and, such exercise of powers as there have been, have only been judicially tested a handful of times. Each case needs to be assessed in its own factual matrix. In each case, including this one, common threshold questions on the operation of the BRRD should first be explored, including the following:

#### ***1. Did the Retransfer Itself Constitute the Exercise of a “Resolution Action” Within the Meaning of the BRRD?[5]***

Could the retransfer itself be said to constitute a “resolution action”?[6] Since, in accordance with Article 40(9) of the BRRD, Novo Banco (as bridge institution), is to be deemed a “continuation” of BES (as the institution under resolution), the retransfer could arguably be said to have been an exercise of a resolution power to “transfer liabilities” within the meaning of Article 63(1)(d) of the BRRD.

#### ***2. Were the Conditions Set Out in the BRRD for Exercise of the “Resolution Action” Satisfied?[7]***

If the retransfer by BDP in the 2015 resolution qualifies as the exercise of a resolution action, the question then arises as to whether the conditions for the exercise of the “resolution action” were satisfied at the time of exercise (i.e. Dec. 29, 2015). The BRRD sets a high bar for a resolution authority to exercise the extraordinary resolution powers in the BRRD. In short, these conditions require BDP to form the view that:[8]

- a. Novo Banco is “failing or likely to fail”;
- b. there is no reasonable prospect that an alternative private sector measure would prevent the failure; and

c. the retransfer is necessary in the public interest.[9]

The BRRD sets out guidance on the meaning of each of these conditions.[10] According to any natural reading of the guidance and without further explanation by BDP, the reasons given for the retransfer in the December press release (namely the “negative effect” on Novo Banco’s “financial situation” a blanket statement (without reasons) that the retransfer was in the “public interest and aimed at safeguarding financial stability”) are insufficient to conclude that these conditions are met.

### ***3. Did BDP Duly Exercise the “Resolution Action” Under the BRRD?[11]***

A due exercise of a resolution action requires the resolution authority to have regard to the resolution objectives, to choose the resolution tools that best achieve the objectives applicable in the circumstances, to seek to minimize the cost of the resolution tools, and to avoid destruction of value unless necessary to achieve the resolution objective. Again, essential information to appropriately evaluate this is missing.

### ***4. The Scope of the “Retransfer” Right***

In its December press release, BDP seems to have assumed that it was entitled to cut across these threshold requirements and effect the retransfer solely in reliance on the retransfer power given to it in the 2014 resolution, which expressly authorized BDP to retransfer assets and liabilities “at any time ... between BES and Novo Banco” in accordance with Article 145-H(5) of the Legal Framework.[12] The BRRD itself contemplates retransfers of liabilities from the bridge institution to the institution under resolution provided they are done in compliance with the conditions set out in the original resolution and “for the relevant purpose.”[13]

Given the context within which the retransfer right sits in the BRRD,[14] it is at least arguable that it cannot properly be construed as an unconditional power. For instance, holders should be asking whether the retransfer right may legitimately be used as a back-door means to breach the BRRD’s fundamental requirement that resolution authorities treat creditors in the same class in an equitable manner.[15] Had BDP purported to pick and choose such liabilities on the initial transfer to Novo Banco in the 2014 resolution, it would have been a clear breach of one of the general principles governing resolution.

Without further explanation, it is not clear why other liabilities of Novo Banco that rank *pari passu* with the affected liabilities remain with Novo Banco, while at the same time it was “necessary in the public interest” to retransfer the affected liabilities from Novo Banco to BES. The convenience for BDP in choosing Portuguese law-governed bonds only is obvious: no questions of recognition by foreign courts will arise, and it seems that foreign courts will not have jurisdiction to hear disputes brought by disgruntled holders. Holders will likely be required to bring their complaint, at least in the first instance, in the Portuguese courts.

### **Remedies for Disgruntled Holders?**

While the BRRD does contain certain explicit safeguards, the remedies for affected stakeholders (such as the holders) are limited.[16] A right of appeal against the 2015 resolution should be available to holders,[17] but the launching of an appeal will not alter the immediate effectiveness and enforceability of the 2015 resolution.[18] The courts are required to use the economic assessments of the facts carried

out by the resolution authority as a basis for their own assessment, and the burden of proof will lie with the party launching the appeal.

If holders are successful in mounting a challenge, there may be two likely outcomes. One possibility is that the 2015 resolution may be annulled and the affected liabilities put back to Novo Banco. But even if the affected liabilities are put back, the holders will not necessarily be home and dry, since the BDP will still need to address the shortfall. What action is likely is difficult to speculate about at this stage and will require more information about Novo Banco. Alternatively, compensation may be awarded to holders against BDP, the monetary value of which will likely involve a comparison between the value of the affected liabilities as a result of BDP's unlawful action, on the one hand, and the value of the affected liabilities had the BDP lawfully exercised its power to address the shortfall.

If, on the other hand, holders are not successful in challenging the 2015 resolution, holders could still be entitled to compensation if the so-called "treatment valuation" within the meaning of Article 74 BRRD shows that the holders have incurred greater losses than they would have incurred in a winding up of Novo Banco under normal insolvency proceedings[19].

## **Conclusion**

The retransfer contained in the 2015 resolution raises a number of questions highlighted here. More information is clearly required to properly assess (both legally and otherwise) this latest twist in the continuing Novo Banco/BES saga. As one of the primary sources of the missing information, we would expect holders to not only attempt to engage with BDP, but at the same time also consider more formal and rigorous steps. Another test case for the BRRD is in the making, so it would seem.

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[1] See "The Banking Recovery and Resolution Directive — Should Creditors Be Concerned?" in Pratt's Journal of Bankruptcy Law, November/December 2014, pp. 607-619 and "Takeaways From Europe's Application Of Bank Recovery Law" in Law360, Sept. 8, 2015 (<http://www.law360.com/articles/699799/takeaways-from-europe-s-application-of-bank-recovery-law>) the "Law360 publication").

[2] Goldman Sachs International v. Novo Banco SA [2015] EWHC 2371 (Comm). See our previous report on this decision in the Law360 publication.

[3] Goldman Sachs International v. Novo Banco SA [2015] EWHC 2371 (Comm). See also footnote 3 above.

[4] Note that the press release also stated that Novo Banco successfully completed the ECB Banking Supervision stress test in the most likely baseline scenario (CET1 ratio of 8.24 percent, above the 8 percent threshold).

[5] Article 32(1). Note also that the BRRD must be complied with regardless of the fact that a resolution authority's actions only affect instruments governed by the laws of its home member state. Prior to the BRRD, BDP could have effected the retransfer by its own sovereign powers since it was not purporting to affect non-Portuguese law instruments and therefore had no need to invoke recognition by other member states under CIWUD. (Directive of the European Parliament and of the Council of April 4, 2001 on the Reorganisation and Winding up of Credit Institutions (2001/24/EC). (Subject to compliance with the Human Rights Directive).

[6] "Resolution action" is defined in Article 2(1)(40) BRRD (in relevant part) as "the decision to place an institution or entity ... under resolution pursuant to Article 32 or 33, the application of a resolution tool, or the exercise of one or more resolution powers."

[7] Article 32(1)(a) – (c).

[8] Article 32(1) BRRD.

[9] According to Article 32(5) of the BRRD, this is the case if (1) it is necessary for the achievement of one or more of the resolution objectives, (2) it is proportionate to one or more of the resolution objectives, and (3) the winding up of Novo Banco under normal insolvency proceedings would not meet those resolution objectives to the same extent.

[10] See Article 32(4) BRRD for scope of "likely to fail."

[11] Articles 31 (resolution objectives) and 34 (general principles governing resolution) BRRD.

[12] The "legal framework" is the Regime Geral das Instituições de Crédito e Sociedades Financeiras. (Article 145-H(5) seems to be an incorrect cross reference; the more likely provision being Article 145-H(4), which, in its terms, appears to provide an unconditional right to transfer liabilities from the bridge bank back to the original institution).

[13] Article 40(7) BRRD.

[14] An underlying rationale of the BRRD seems to be that "exceptional circumstances require exceptional powers." When an exceptional power is used, exceptional circumstances must therefore exist to merit its use. It would therefore be surprising if the fact that the 2014 resolution met the BRRD requirements on Aug. 3, 2014, is sufficient for the 2015 resolution and there would be no need to verify again on Dec. 29, 2015, if the BRRD requirements are met in respect of the retransfer.

[15] Article 34(1)(f) BRRD. See also recital 47 ... In particular, where creditors within the same class are treated differently in the context of resolution action, such distinctions should be justified in the public interest and should be neither directly nor indirectly discriminatory on the grounds of nationality ....")

[16] This is underscored by the far-reaching effects of the exercise of resolution powers that follow from, inter alia, the following BRRD articles: Article 37(8) BRRD [clawback rights are disapplied], Article 68 BRRD [exclude effectiveness of certain contractual provisions], Article 70 BRRD [suspend certain contractual terms], Article 71 BRRD [restrict enforcement of security rights], Article 72(4) BRRD [shadow/de facto director laws are disapplied], and Article 86(1) BRRD [restrict opening of normal insolvency proceedings].

[17] Article 85(3) BRRD.

[18] Article 85(4) BRRD.

[19] Article 75 BRRD.

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