

NEW ARTICLE 55 BRRD BAIL- IN WAIVER

More time available to review and amend contracts
Financial Services

Contractual Recognition of Bail-In provisions required for many foreign law governed commercial contracts

Introduction and Background

The Bank Recovery and Resolution Directive (2014/59/EU) (**BRRD**) gives wide-ranging powers to EU resolution authorities (in the UK, the Bank of England) to increase the capital of a failing institution by writing down, reducing, cancelling or converting liabilities held by unsecured creditors (known as "bailing-in"). As there may be no automatic recognition of any resolution action with respect to non-EEA governed contracts, and, in order to effect a level playing field with regard to non-EEA liabilities, BRRD includes a requirement at Article 55 for **Contractual Recognition of Bail-In** of creditors in respect of a wide range of liabilities in non-EEA governed contracts.

The new contractual provision must provide that the creditor recognises and agrees that the liability may be subject to the exercise of the bail-in tool by the Bank of England as the resolution authority. The requirement applies to banks, building societies and designated investment firms which are subject to the BRRD (each a **BRRD Undertaking**) with respect to contracts issued or entered into after the relevant implementation date.

The PRA had phased in the Contractual Recognition of Bail-In requirement, making it applicable to unsecured debt instruments, additional tier 1 instruments and tier 2 instruments ("phase 1" liabilities) from 19 February 2015, and to all other relevant liabilities created under the scope of the rule ("phase 2" liabilities) from 1 January 2016.

On 25 November 2015, the PRA issued a modification by consent of certain rules in the Contractual Recognition of Bail-in Part of the PRA Rulebook (through which Article 55 of the BRRD has been transposed). In consequence, affected institutions can apply for a waiver disapplying the application of the contractual bail-in requirement, for "phase 2" liabilities from 1 January 2016 where compliance with them is "impracticable". The modification ends on 30 June 2016 (or earlier if the relevant rules are amended or revoked before then). The effect of the waiver is to delay the implementation of "phase 2" liabilities to **30 June 2016**. The PRA intends to consult on an amendment to its rules to replace the need for a waiver.

This delay is welcome news as many participants in the sector have voiced concerns to both the PRA and the European Banking Authority that these requirements would have a significant negative impact on BRRD Undertakings. This is due to their broad application and the practical issues involved in seeking to include the Contractual Recognition of Bail-In language in existing agreements (which in most cases would require re-negotiation with contract counterparties).

Do you have contracts governed by non-EEA laws or a contract that is otherwise capable of creating a liability that is governed by the law of a non-EEA country?

BRRD Undertakings are required to include a contractual term by which the other party to the agreement recognises that relevant liabilities¹ may be subject to the write-down and conversion powers required by the BRRD. The other party needs to agree to be bound by any reduction of the principal or outstanding amount due, or by any conversion or cancellation that is effected by, the exercise of those powers by the Bank of England as resolution authority. All liabilities are deemed to be subject to Bail-in, unless expressly excluded (see box below).

A BRRD Undertaking, therefore, needs to consider which of its contracts need to be altered to include a new provision recognising these rights. The need for Contractual Recognition of Bail-In will apply to a wide range of non-EEA law contracts that are not *critical* to the daily functioning of the BRRD Undertaking's operations. These will likely include, among other liabilities, loan agreements, share and debt instruments, trade finance (letters of credit), operational liabilities, liabilities to non-EU financial market infrastructures, uncovered corporate deposits, financial instrument trading arrangements, indemnities and guarantees, etc. Notably, new in-scope liabilities created after the implementation date under a pre-existing master agreement must contain the contractual provision, and any subsequent material amendment of an agreement would trigger the requirement.

¹ Debt or liability to which the BRRD Undertaking is subject, whether it is present or future, certain or contingent, ascertained or sounding only in damages.

Determining whether the contract creates non-EEA liabilities – is the contract international?

The Contractual Recognition of Bail-In requirements affect agreements that create liabilities that are governed by the law of a non-EEA state unless an exception applies. The nature of the Exceptions does not lend itself to a quick tick box exercise. A good starting point is to determine whether the contract has a non-EEA international element by reviewing the governing law clause of the contract. However, while there is a high correlation between the governing law clause and whether or not a contract will create a liability that is *governed by* the law of a non-EEA state, this may not be the end of the story.

For many contracts the analysis will be straightforward. For example, a contract which is governed by English law and only deals with UK activities will not be affected by Article 55. However, applying the test to contracts dealing with complex global trading activities may give rise to tricky issues; for example, where BRRD Undertakings have non-EEA branches entering into agreements without governing law clauses.

Complexity may also arise where a variety of applicable laws apply to a contract and relevant sub-contracts (for example, a global distribution agreement), under which a party is authorised to undertake activities outside the EEA and as a result of which, liabilities may be created for a BRRD Undertaking (i.e. an agent contravening local laws and regulations). In such circumstances, it is necessary to examine the provisions of the contract, conflict of laws principles and the exceptions to the Contractual Recognition of Bail-In requirements more closely.

Does an exception apply or is there a local law carve out?

Contractual Recognition of Bail-In will not be necessary, even if the contract creates liabilities governed by the law of a non-EEA jurisdiction, where:

- one of the Exceptions applies, or
- the relevant non EEA state has bail-in recognised by operation of its law; or
- the relevant non EEA state has a binding agreement with the PRA (recognising bail-in).

Exceptions to the need for Contractual Recognition of Bail-In

While the category of in-scope liabilities is wide, exceptions include (each an **Exception**), inter alia:

- ▶ eligible deposits (all deposits of natural persons and Micro-enterprises and SMES);
- ▶ secured liabilities (but only to the extent of the value of any security);
- ▶ certain fiduciary relationships;
- ▶ liabilities to institutions, excluding entities that are part of the same group, with an original maturity of less than seven days;
- ▶ certain liabilities with a remaining maturity of less than seven days, owed to systems or operators of systems or their participants and arising from participation in such a system;
- ▶ liabilities to employees, in relation to accrued salary, pension benefits or other fixed remuneration;² and
- ▶ liabilities to commercial or trade creditors arising from the provision of goods or services that are **critical** to the daily functioning of operations (including, for example, relevant IT services, utilities and the rental, servicing and upkeep of premises)

² Except for the variable component of remuneration that is not regulated by a collective bargaining agreement.

What should the Contractual Term contain?

A contractual term must include:

- (a) the acknowledgement and acceptance by the entity's counterparty that the liability may be subject to the exercise of write-down and conversion powers by a resolution authority;
- (b) a description of the write-down and conversion powers of each resolution authority;
- (c) the acknowledgment and acceptance by the entity's counterparty:
 - (1) that it is bound by the effect of an application of the resolution authority's powers including:
 - (a) any reduction in the principal amount or outstanding amount due, including any accrued but unpaid interest, in respect of the liability of an entity under the relevant agreement;
 - (b) the conversion of that liability into ordinary shares or other instruments of ownership;
 - (2) that the terms of the relevant agreement may be varied as necessary to give effect to the exercise by a resolution authority of its write-down powers and such variations will be binding on the entity's counterparty;
 - (3) that ordinary shares or other instruments of ownership may be issued to or conferred on the entity's counterparty as a result of the exercise of the write-down and conversion powers; and
- (d) the acknowledgement and acceptance by the entity's counterparty that the contractual term is exhaustive - to the exclusion of any other agreements, arrangements or understandings between the counterparties relating to the subject matter of the relevant agreement.

BRRD undertakings must be able to provide authorities with a legal opinion on the enforceability and effectiveness of the contractual term.

Practical challenges

There are many scenarios where the waiver will be helpful to BRRD undertakings even if it only provides an additional period within which to comply. Some examples are:

- ▶ determining which law applies to the contract where there is no governing law clause;
- ▶ identifying the scope of the liabilities where there is a complex international contractual framework with non-EEA parties;
- ▶ negotiating with counterparties who have no incentive to agree to revised terms especially in countries unfamiliar with the concept of bail-in and where their own banks do not require such provisions;
- ▶ whether contingent liabilities such as letters of credit would, in fact, be bailed-in and, hence, how resolution authorities should deal with these liabilities;
- ▶ where it is possible to impose contractual terms unilaterally, for instance, the use of standard terms of business. Issues have been encountered with obtaining buy-side adherence to the ISDA Resolution Stay Protocol;
- ▶ contracts governing operational liabilities which cannot be readily negotiated including contracts with public authorities and those whose terms are prescribed under local law (e.g. acquisition of land, leases, acquisition and rental of equipment or supplies, car rental, flights, hotel rooms, utilities etc.); and
- ▶ one size may not fit all as relevant contractual provisions will need to be tailored to the jurisdiction of the entity and the relevant contract.

Key steps for firms

- 1 Establish appropriate systems and controls as well as processes and procedures to identify affected contracts and whether they comply.
- 2 Determine which specific contracts are affected by Contractual Recognition of Bail-in.
- 3 Consider making an application to the PRA for a waiver extending the time for compliance.
- 4 Ensure that all new affected contracts entered into after the relevant implementation date comply with the requirements.
- 5 Where existing contracts are subject to material amendment, consider whether they can be amended so as to comply.
- 6 Use industry standard templates where possible, and where bespoke clauses are necessary, draft flexible clauses which can easily be adapted to a wide range of agreements.
- 7 Work with counterparties to explain the requirement.
- 8 Consider the consequences if a counterparty cannot be persuaded to agree to Contractual Recognition of Bail-in.
- 9 While not obligatory for "phase 2" liabilities, in complex cases consider if an independent and reasoned legal opinion in respect of the "enforceability and effectiveness" of the contractual bail-in term may be required.

How can we help?

The Financial Regulation Group at Addleshaw Goddard has a wealth of experience in conducting regulatory and contractual reviews, so as to provide senior management with comfort that there are adequate systems and controls in place to provide reasonable assurance over compliance with Article 55 BRRD. We can assist in reviewing contracts to identify whether there are liabilities subject to the Contractual Recognition of Bail-in requirements and provide support in drafting the appropriate contractual provisions. We also have significant experience working with regulators, including making applications for rule waivers and can advise and support you as needed.

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