EU bank resolution framework: A comparative study on the relation with national private law

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5 European bank resolution framework: bail-in mechanism[1]

1 Introduction

This chapter focuses on the legal framework on bail-in. The BRRD and SRM Regulation distinguish between two types of tools for effecting the write-down and conversion powers, i.e., the write-down or conversion of capital instruments and eligible liabilities tool and the bail-in tool. The tools are here together referred to as 'bail-in mechanism' and their application as 'bail-in'. The analysis is structured as follows. Paragraph 2 briefly examines conceptual aspects of the bail-in mechanism from a regulatory perspective and an insolvency law perspective. Paragraph 3 discusses the bail-in mechanism as codified in the BRRD and SRM Regulation. Paragraphs 4 and 5 then investigate several prominent relations between the objectives, principles, and rules of the national legal frameworks on bail-in on the one hand, and national private law on the other hand. The analysis illustrates how the domestic legal frameworks on bail-in interact with and how they have been embedded into private law.

More specifically, the main question in paragraph 4 is whether the national legal frameworks on bail-in and the national company and general insolvency laws share some important principles, especially from the perspective of the trend in the EU to introduce corporate restructuring procedures as an alternative to traditional court-centered procedures. Hence, this paragraph investigates the deeper levels of the national legal orders, namely the principles.

Paragraph 5 then analyzes three sets of bail-in rules. It will be shown in this paragraph that the national legislatures closely aligned some of the rules with existing fields of national private law by, for instance, replicating existing private law rules and concepts for the bank resolution framework. The paragraph also shows that other bail-in rules explicitly depart from national private law and that the connection of some rules with private law is unclear. Moreover, the sections indicate that both differences in national substantive insolvency law and different national solutions for the application of the bail-in rules may create divergent outcomes in bank resolution procedures across jurisdictions.

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1 This chapter contains and builds on the following work previously published by the author: Janssen 2018a; Janssen 2018b; Janssen 2017.

Paragraph 5.1 discusses the effects of a reduction of liabilities of a bank by a resolution authority on the claims themselves and related guarantees under national law. The next paragraph examines whether conversion of debt to equity in bank resolution follows the formalities and practice normally followed for such conversion in a financial restructuring under national law. Paragraph 5.3 scrutinizes how the hierarchy of claims in bail-in, including the protection offered by the bail-in rules to several types of claims by excluding them from bail-in, relates to the insolvency ranking of claims recognized under national law.

2 Conceptual aspects of the bail-in mechanism from a regulatory and insolvency law perspective

2.1 Bail-in mechanism from a regulatory perspective

The function of the share capital of any stock company has been considered threefold. Firstly, the capital, which is provided by the shareholders who benefit if the company can pay dividends but are in insolvency only paid after all creditors of the company, enables the company to finance its daily activities. Secondly, it serves as a basis for apportioning each shareholder a share in the control over the company. Finally, for the company's creditors, it is considered to form a 'buffer' and guarantee that the company can continue its activities and fulfill its commitments in the foreseeable future.[2]

In contrast to many other companies, banks are required to hold an adequate level of regulatory capital that is composed of a layer of share capital as well as a mix of subordinated debt and hybrid capital.[3] A thick layer of this regulatory capital may ensure that in a collective insolvency procedure, shareholders and investors in subordinated debt rather than the bank's depositors and the wider economy, shoulder a large part of the losses. Outside such a formal insolvency procedure, however, the mere subordination of debt, in principle, does not provide any help in absorbing losses made by the bank.[4]

2 Olaerts 2003, p. 4; Schutte-Veenstra 1991, p. 6-7.

3 For a theoretical discussion of the functions and structure of a bank's capital, *see* Diamond & Rajan 2000, p. 2431-2465.

4 Gleeson & Guynn 2016, p. 196; Gleeson 2012, p. 14; Financial Services Authority, 'A regulatory response to the global banking crisis', Discussion Paper 09/2, March 2009, p. 62-70. *See also* Cahn & Kenadjian 2015, p. 218-219; Kenadjian 2013, p. 229 who argues that loss-absorbing capital and debt instruments are essential because banks 'operate with a very thin equity capital layer of a few percent, one that would be inconceivably think outside the financial sector, which can be eaten through every quickly by losses and which, as we saw in the 2008/2009 crisis, can be very hard to replace, especially in the midst of a crisis.'

Therefore, over the past several years an important aspect of the regulatory reforms in the EU has been restricting capital and debt instruments that qualify as regulatory capital. A part of the regulatory capital must now have a so-called 'loss-absorbing capacity' much earlier than the moment the bank meets the requirements for the opening of an insolvency procedure.[5] Contingent capital instruments, such as contingent convertible bonds (CoCos) and write-down bonds, have acquired increasing support from the banking sector, regulators, and academics.[6] The terms and conditions of these instruments have a clause generally providing that they are written down or they are converted into equity when a predetermined trigger event occurs.[7] Thus, it ensures the possibility of a reduction of debt through write-down or a share capital increase through conversion of debt.[8] Under the Capital Requirements Regulation[9] (CRR) capital instruments may only count as Additional Tier 1 (AT1) instruments if the instruments can absorb losses at a trigger point that relates to a bank's Common Equity Tier 1 (CET1) capital ratio.[10]

A statutory bail-in mechanism is to be considered a supplement to these contingent capital instruments issued by banks.[11] It allows authorities to recapitalize a bank by ordering the write-down of capital instruments and liabilities so that losses are absorbed and requiring a subsequent conversion of debt into share capital so that the bank or a successor entity is provided with new capital. While contingent capital instruments can be triggered if the issuing bank's operations are still considered going concern, the bail-in mechanism may be applied in a wider range of circumstances. The application depends on the exercise of discretion by the resolution authority rather

5 *See* Schillig 2016, p. 281-285; Gleeson & Guynn 2016, p. 196-198; Joosen 2015, p. 187 *et seq.*; Cahn & Kenadjian 2015, p. 218-219; Kenadjian 2013, p. 229; Gleeson 2012, p. 14.

6 *See* e.g., Schillig 2016, p. 281-285; Avdjiev et al. 2013; Pazarbasioglu et al.; Calomiris & Herring.

7 *See* Gleeson 2012, p. 14; Pazarbasioglu et al. 2011, p. 4; Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems', December 2010, revised version June 2011; Basel Committee on Banking Supervision, 'Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability', August 2010, p. 4-5.

8 *See* Schillig 2016, p. 283.

9 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

10 Articles 52(1)(n), 54(1), 92(1)(a) CRR; Joosen 2015, p. 216-221. Article 54(1)(a) CRR defines the trigger event as the situation when the CET1 capital ratio referred to in article 92(1)(a) CRR falls below either (1) 5,125 percent or (2) a higher level than 5,125 percent, where determined by the bank and specified in the provisions governing the instrument. Under article 54(1)(b) CRR, insitutions may specify in the terms and conditions of the issued instrument one or more trigger events in addition to that referred to in point (a).

11 *See* Joosen 2015, p. 228; Bliesener 2013, p. 191; Kenadjian 2013, p. 229-230; Zhou et al. 2012, p. 6.

than a contractually agreed trigger event.[12] Accordingly, in practice, the trigger of the application of the contingent capital instruments may not always precede the use of the bail-in mechanism. The implementation of the statutory bail-in may also follow the occurrence of the contractual trigger event.[13]

Hence, a statutory bail-in mechanism is intended to serve the function of ensuring a 'private penalty' or 'private insurance'. Losses are imposed on the persons who have some form of financial claim against the bank rather than on the general public.[14] It facilitates a swift restructuring of the balance sheet of the bank.[15] The mechanism also ensures that not only share capital and other forms of regulatory capital but also other types of liabilities of a bank now fulfill the function of standing at the top rungs of the loss distribution ladder and provide a financial buffer.[16]

Nonetheless, this does not necessarily mean that resolution authorities consider bail-in the most appropriate resolution strategy for all types of bank failures. For example, the BoE believes that application of the bail-in mechanism is the most appropriate resolution measure to recapitalize the largest and most complex UK banks in case of their failure. The balance sheets of these banks are said to be so complex and highly interconnected with the broader financial system that other types of resolution measures may not be possible or desirable in practice. These measures include a break-up and sale of a part of the failing bank or a transfer of the part to a bridge institution.[17] At the same time, scholars warn that the use of the bail-in mechanism, and especially its application in case of a large, systemic

12 *See* Joosen 2015, p. 216; Gleeson 2012, p. 15.

13 Schillig 2016, p. 283-284. Joosen 2015, p. 229 calls it a 'double dip'. Hoeblal & Wiercx 2013, p. 272 call it a 'tweetrapsraket die noodlottige gevolgen lijkt te hebben voor een crediteur die op basis van contractuele voorwaarden als pleister op de wonde een aandelenbelang wist te verwerven, maar datzelfde belang vervolgens weer op het spel ziet staan door een besluit van de afwikkelingsautoriteit.'

14 *See* Tröger 2015, para. 3.2; Avgouleas & Goodhart 2015, p. 4, who both refer to Huertas 2013, p. 167-169 for the discussion of the replacement of the public subsidy with a private penalty, and to Gordon & Ringe 2015, p. 1300 and KPMG, 'Bail-in liabilities: Replacing public subsidy with private insurance', July 2012 (available at http://www.bankinggateway.com/downloads/whitepapers/core-banking-systems/bail-in-liabilities/) for the concept of private insurance or self-insurance. For the comparison of the bail-in mechanism with insurance, *see also* Zhou et al. 2012, p. 7. For a discussion of the concept of burden sharing in the context of bank resolution, *see* Gardella 2015, p. 376 *et seq.*; Grünewald 2014. *Cf.* Joosen 2015, p. 222, arguing that '[i]n the BRRD the bail in mechanism is placed in the context of penalization of creditors and shareholders, rather than a burden sharing mechanism that was the original concept of the international authorities advocating the contingent capital mechanism.'

15 *See* Sommer 2014, p. 217.

16 Wojcik 2016, p. 112; Binder 2015a, p. 108; Sommer 2014, p. 222.

17 Bank of England, 'The Bank of England's approach to resolution', October 2017, p. 16.

bank failure, may trigger a panic amongst creditors and spread financial problems to other parts of the financial system. If other banks hold many bail-inable liabilities, for instance, bail-in weakens the overall stability of the banking sector. The application of the mechanism or news about its possible use is expected to create incentives for creditors to withdraw their deposits and sell their claims on a large scale, which further weakens the balance sheets of banks. The present author agrees with these scholars that in these cases with contagion risks, bail-in may have to be coupled with an injection of some form of public funds to counter the threat of large-scale disruption to the financial system.[18] Contagion risks also require authorities to set limits on the cross-holdings of bail-inable instruments by other financial institutions, to impose a temporary stay on actions of certain counterparties against a distressed bank, and to exclude certain liabilities from the application of the bail-in mechanism.[19]

2.2 Bail-in mechanism from an insolvency law perspective

The concept of bail-in may remind insolvency lawyers of the so-called 'chameleon equity firm', which was proposed by Adler many years ago.[20] In brief, this company issues debt in several tranches. When it shows signs of financial distress, the claims in the classes are retained to the extent the claims can be met. The highest tranche that cannot be paid is automatically converted into equity, whereas the remaining lower layers, including the original equity class, are automatically wiped out, as was contractually specified. In this way, the firm can continue its operations with a group of former creditors having control over the firm as shareholders.[21]

In a similar form, a statutory bail-in mechanism creates an alternative type of financial restructuring procedure in which the bank as the debtor is relieved from a part of its debt burden. It can also be said to be a means to mirror loss absorption in an insolvency procedure.[22] Its purpose is to produce the ex-ante effect of imposing market discipline and minimizing moral hazard. As indicated in chapter 2,[23] investors are expected to be alert about the financial position of the bank and to price bank capital accordingly if they know that losses are primarily by borne by them.[24]

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18 Schoenmaker 2018; Avgouleas & Goodhart 2015, p. 21-22 and 29.
19 *See* Schoenmaker 2018; Zhou et al. 2012, p. 22.
20 Adler 1993, p. 311-346. For a discussion of Adler's proposal, *see also* Schillig 2016, p. 281, who discusses the chameleon equity firm in the context of contingent capital and bail-in.
21 Adler 1993, p. 323 et seq.
22 Grünewald 2017, p. 290; Wojcik 2016, p. 107; Burkert & Cranshaw 2015, p. 445; Hadjiemmanuil 2015, p. 233.
23 Paragraphs 2.2.2, 2.2.3 and 3.2.1 of chapter 2.
24 Tröger 2018, p. 41; Avgouleas & Goodhart 2015, p. 4.

The literature also argues that the mechanism illustrates the function of the bank resolution rules in overcoming possible so-called anticommons problems in bank resolution procedures,[25] which problems were already briefly discussed in chapter 2.[26] In theory, a bank has the option to negotiate with its creditors and shareholders on a financial restructuring if it is financially troubled and its shareholders are unwilling to invest additional capital. The measures may include conversion of the outstanding debt into one or more classes of share capital and a debt reduction.[27] It is a contractual solution that requires the consent of all affected shareholders and creditors. Accordingly, the financial restructuring plan does not go ahead, or can only be partially implemented, if some shareholders and creditors hold out during the negotiations by not approving the proposed arrangement. Creditors and shareholders may withhold their consent because they expect to have a chance to have a better individual position without the plan. They may, for instance, speculate that the government bails-out the bank if they do not give their consent to the measures.[28] These problems with hold out behavior of creditors and shareholders are generally known as anticommons problems.[29] The solution to anticommons problems offered by the bank resolution rules is that an administrative decision overrules the shareholders and creditors of a bank. For example, as is further considered in paragraph 4.3 below, the bail-in rules empower the resolution authority to decide on and implement the necessary financial restructuring measures, although with the safeguard for the affected shareholders and creditors that they will not be made worse off than in a hypothetical insolvency procedure.[30]

3 Bail-in mechanism as codified in the BRRD and SRM Regulation

The BRRD and SRM Regulation divide a resolution authority's bail-in powers between two different instruments, but many characteristics of the tools are the same. The first instrument is the write-down or conversion of capital instruments and eligible liabilities tool, which is not a resolution tool within the definition of the BRRD and SRM Regulation.[31] The literature has

25 Schillig 2016, p. 61-66; De Weijs 2013.
26 Paragraph 2.2.1 of chapter 2.
27 At the end of 2016, bondholders of the Italian Banca Monte dei Paschi di Siena were proposed a voluntary conversion of their claims into equity. Yet, not enough bondholders approved the plan.
28 De Weijs 2013, p. 217-221.
29 De Weijs 2013, p. 210-215; De Weijs 2012.
30 De Weijs 2013, p. 217-221.
31 In the parliamentary notes to the Dutch Part 3a Wft, the write-down or conversion of capital instruments and eligible liabilities tool is called the 'AFOMKI' tool (AFschrijven of OMzetten van KapitaalInstrumenten). *See* Explanatory Notes to the Draft BRRD Implementation Act (*Kamerstukken II* 2014/15, 34208, no. 3), p. 17-18.

called its application a 'Kleiner Bail-in'.[32] Its scope is limited to a bank's so-called 'relevant capital instruments', which are AT1 and Tier 2 (T2) instruments,[33] and so-called 'eligible liabilities', which meaning is further discussed below. The tool is exercised either independently of a resolution procedure and before the conditions for resolution are met, or in combination with the application of the resolution tools if a resolution procedure has been commenced.[34] In the former case, a resolution authority can only use the instrument in relation to eligible liabilities if the bank has issued these eligible liabilities internally within the banking group.[35] Shares, reserves, and other CET1 items of the bank are always written down before this tool is applied.[36]

The second bail-in instrument is the bail-in tool, which is part of the resolution authority's toolbox in a resolution procedure. The resolution authority applies the tool following the application of the write-down or conversion of capital instruments and eligible liabilities tool. It can use the bail-in tool to recapitalize the bank under resolution. It may also exercise the tool to capitalize a bridge institution to which claims or debt instruments of the bank are transferred, or complement the application of the resolution tools to transfer parts of the bank to a private sector purchaser or asset management vehicle.[37] Thus, the measures can be taken in relation to the existing bank, which the literature calls an open-bank bail-in, as well as to a non-operating firm while a part of the business are transferred to a new entity, which scholars often call closed-bank bail-in.[38] In the former case, the BRRD and SRM Regulation do not allow that the financial restructuring measures are applied in an isolated manner but require that they are accompanied with the creation of a reorganization plan that sets out measures to restore the bank's long-term viability.[39] As paragraph 5.3 further discusses, not all

32 Hübner & Leunert 2015, p. 2263.
33 Article 2(1)(74) BRRD; Article 3(1)(51) SRM Regulation.
34 Articles 37(2), 59(1) BRRD; Articles 21(7), 22(1) SRM Regulation.
35 Article 59(1) BRRD; Article 21(7) SRM Regulation.
36 Article 60(1) BRRD; Article 21(10) SRM Regulation. *See* Huertas 2016, p. 16, who notes that '[s]trictly speaking, common equity is not subject to bail-in as it already bears first loss and is the instrument in which bail-in may convert other liabilities.' and *see* European Banking Authority, Consultation Paper, Draft Guidelines on the treatment of shareholders in bail-in or the write-down and conversion of capital instruments, EBA/CP/2014/40, p. 5, which sets out at '[s]hareholders sit at the bottom of the insolvency creditor hierarchy, and are therefore the first creditors to absorb losses on both a going-concern basis and in an insolvency. This position should be reflected in resolution, where shareholders should also be the first to absorb losses, and do so before more senior creditors.'
37 Article 43(2) BRRD; Article 27(1) SRM Regulation. *See* Wojcik 2016, p. 107.
38 *See* Binder 2015a, p. 109-110. On these two different resolution approaches, i.e., the open bank bail-in and the closed bank bail-in approach, *see* Krimminger & Nieto 2015, p. 5; Chennells & Wingfield 2015, p. 234.
39 Article 52 BRRD; Article 27(16) SRM Regulation.

liabilities fall within the scope of the resolution authority's bail-in tool and the bail-in powers are to be applied tranche by tranche,[40] following to a large extent 'a reverse order of priority of claims'[41] under national insolvency law.[42]

To ensure that banks have a sufficient amount of capital instruments and liabilities on their balance sheets that can be made subject to the bail-in mechanism, resolution authorities require banks to meet at all times a minimum requirement for bail-inable capital instruments and liabilities. The requirements are known as the Minimum Requirement for own funds and Eligible Liabilities (MREL) and Total Loss-absorbing Capacity (TLAC).[43] The BRRD calls the bail-inable liabilities that count towards the MREL or TLAC requirement of a bank 'eligible liabilities'.[44] The resolution authority may exercise the write-down or conversion of capital instruments and eligible liabilities tool in relation to these eligible liabilities.[45] The requirements aim to ensure that a large part of the losses can be absorbed and that the bank can subsequently be recapitalized, although the recapitalization requirement as part of the standards does not apply to a bank that is expected to be liquidated.[46]

A simple example illustrates the application of the bail-in mechanism under the BRRD and SRM Regulation.[47] Suppose the ECB as competent supervisory authority concludes that a bank needs to take a substantial loss on

40 *Cf.* G. Franke et al. 2014, p. 565, who compare the hierarchy of liabilities in bail-in to a securitization transaction in which also several tranches are distinguished.

41 Wojcik 2016, p. 111.

42 Article 48 BRRD; Article 17 SRM Regulation.

43 Articles 45-45m BRRD; Articles 12-12g SRM Regulation; Article 72a-72l and 92a CRR; Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities (OJ L 237, 3.9.2016, p. 1).

44 Article 2(1)(71a) BRRD; Article 3(1)(49a) SRM Regulation; Article 72a CRR. Before entry into force of the recent amendments to the BRRD, the liabilities that were not excluded from bail-in were called 'eligible liabilities'. The term 'eligible liabilities' is now used for debt that counts towards MREL under articles 45-45k BRRD. 'Bail-inable liabilities' is the term now used for the capital instruments and liabilities that do not qualify as CET1, AT1 and T2 instruments and are not excluded from the scope of bail-in under article 44(2) BRRD. *See* Article 2(1)(71) BRRD.

45 Articles 59 and 60 BRRD; Article 21 SRM Regulation.

46 Article 45c(2) BRRD; Article 12d(2) SRM Regulation; Article 2(2) Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities (OJ L 237, 3.9.2016, p. 1).

47 For a detailed discussion of the application of the bail-in mechanism, s*ee also* e.g., Wojcik 2016, p. 111; Gleeson & Guynn 2016, p. 177-181 and 190-192; Schelo 2015, p. 121-125; Andrae 2014, p. 30-31; Gleeson 2012, p. 5-8.

its loan book and therefore no longer complies with the regulatory capital requirements. It decides together with the SRB that it meets the conditions for the opening of a resolution procedure.[48] Based on a valuation of the bank's assets and liabilities and a resolvability assessment and resolution plan that have been made beforehand, the SRB assesses which resolution actions need to be taken, what part of the bank's capital should be made subject to bail-in measures, and what should in the end be the capital position of the bank, which is in this case the 'target' of the bail-in measures.[49] The BRRD requires that the recapitalization is enough to allow the bank to meet the capital requirements again and to restore market confidence in the bank.[50] The Board then adopts a so-called resolution scheme, which places the bank under resolution and determines the application of the resolution tools.[51]

In this hypothetical case, the resolution authority concludes that it does not combine bail-in with the application of other resolution tools. The resolution scheme enters into force after the European Commission and the Council have not expressed any objections within 24 hours.[52] The Board then sends the scheme to the relevant national resolution authorities, which implement the measures in accordance with the BRRD, as transposed into national law.[53] The write-down or conversion of capital instruments and eligible liabilities tool is in this case first applied to fully write-down the relevant capital instruments and bail-inable liabilities that count towards the MREL. This measure covers the losses made by the bank and returns the difference between the asset side and liability side of the bank's balance sheet (the net asset value) to zero.[54] The next step in this case is the conversion of other liabilities into equity to recapitalize the bank.[55]

It is worth noting that the BRRD and SRM Regulation do not explicitly provide that a resolution authority is empowered to convert a liability of the bank in another type of debt – such as the conversion of a senior liability in subordinated debt that qualifies as an AT1 or T2 capital instrument and, as a result, as regulatory capital. According to the literature, if a resolution authority is empowered to convert a claim against the bank into shares in the bank, it should also be empowered to transform it in a less subordinated position such as a subordinated claim.[56] One can also argue that article 64

48 Article 32(1) BRRD; Article 18(1) SRM Regulation.
49 Articles 10-14, 36(1), (4), 59(10) BRRD; Articles 8-9, 20(1), (5) SRM Regulation.
50 Article 46(2) BRRD.
51 Article 18(1), (6), 23 SRM Regulation.
52 Article 18(7) SRM Regulation. For a more detailed discussion of the decision-making procedure within the SRM, *see* Schillig 2016, p. 147-150; Zavvos & Kaltsouni 2015, p. 127-138.
53 Articles 18(9), 23, 29 SRM Regulation.
54 Article 60(1) BRRD; Articles 21(10)-(11), 29 SRM Regulation.
55 Articles 46, 48(1), 60(1) BRRD.
56 Kastelein 2014, p. 129.

BRRD provides for a legal basis for this conversion because it stipulates that a resolution authority is empowered to modify the terms of a contract to which the bank under resolution is a party when exercising its resolution powers.

4 Parallels between principles of bail-in and principles of corporate financial restructuring outside traditional formal insolvency procedures

4.1 Introduction

Over the past years, not only the rules governing the restructuring of bank debt but also the laws governing the restructuring of financial obligations of non-financial corporate debtors have been paid considerable attention by the EU legislature.[57] In the EU, there has been an increasing focus on pre-insolvency restructuring and 'business rescue' as an alternative to traditional, court-centered insolvency procedures.[58] For example, in 2014 the European Commission adopted a Recommendation that encourages the Member States to amend their national corporate restructuring laws so as

> 'to ensure that viable enterprises in financial difficulties, wherever they are located in the Union, have access to national insolvency frameworks which enable them to restructure at an early stage with a view to preventing their insolvency, and therefore maximise the total value to creditors, employees, owners and the economy as a whole.'[59]

Two years after the publication of the Recommendation, the Commission published a proposal for a directive which, amongst other things, aims to harmonize the substantive rules governing corporate restructuring proce-

57 For an overview of the EU developments in the field of corporate restructuring and insolvency laws since 2011, including the policy documents published by the European Parliament and the European Commission, *see* European Commission, 'Initiative on insolvency', Inception Impact Assessment, 2 March 2016, available at http://ec.europa.eu/smart-regulation/roadmaps/docs/2016_just_025_insolvency_en.pdf; Wessels 2015c, p. 208-212; Eidenmüller & Van Zwieten 2015, p. 633-637; Madaus 2014, p. 82.

58 *See* e.g., Eidenmüller 2017, p. 274-276; Wessels 2015c, p. 207.

59 Recital 1 European Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency, available at http://data.europa.eu/eli/reco/2014/135/oj. According to the Recital, the second objective of the Recommendation is 'giving honest bankrupt entrepreneurs a second chance across the Union.' For a discussion of the Recommendation, *see* Eidenmüller & Van Zwieten 2015. Only a few Member States undertook reforms to implement the Recommendation. *See* Directorate-General Justice & Consumers of the European Commission, 'Evaluation of the Implementation of the Commission Recommendation of 12.3.2014 on a new approach to business failure and insolvency, 30 September 2015, available at http://ec.europa.eu/justice/civil/files/evaluation_recommendation_final.pdf.

dures.[60] The proposed rules exclude banks and other financial institutions from their scope.[61] According to the draft directive, national corporate restructuring frameworks should facilitate a restructuring 'where there is likelihood of insolvency'[62] to enable a debtor to continue operating. Such a 'restructuring' can be a financial restructuring, such as a rescheduling of payments, a debt to equity swap, and a reduction of the value of creditor claims.[63] A restructuring plan shall be deemed to be adopted if the required majority of the debtor's affected creditors in each class agrees with it. If certain conditions are met, one or more classes of creditors in which the necessary majority is reached can also bind one or more dissenting classes.[64] Shareholders may, rather than shall, be allowed to vote on the plan in a separate group.[65] If the arrangement affects the interests of dissenting affected parties, it has to be confirmed by a judicial or administrative authority at the end of the process, which has to check, amongst other things, that the dissenting parties are not worse off under the plan than in the event of liquidation of the debtor's business.[66] An imposition of a restructuring on dissenting creditors and shareholders as included in the proposed directive is in the literature generally called a 'cramdown'.

The EU developments towards the facilitation of pre-insolvency corporate restructuring procedures as an alternative to traditional, court-centered insolvency procedures cannot be studied in isolation from national developments in the field of corporate restructuring and insolvency law. The literature indicates that many EU Member States have recently introduced or proposed rules to reform their domestic restructuring and insolvency legislation, driven by regulatory competition as well as developments during

60 Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU (COM (2016) 723 final, 22.11.2016) ('Proposed Directive on preventive restructuring frameworks'). For an extensive discussion of the proposed directive, *see* Eidenmüller, 2017, who also criticises the proposal because, in his opinion, only economically viable companies should have the opportunity to restructure, and the others should be liquidated. *Cf.* Tollenaar 2016, p. 305-311.

61 Article 1(2) Proposed Directive on preventive restructuring frameworks.

62 Article 4 Proposed Directive on preventive restructuring frameworks.

63 Article 2(2) Proposed Directive on preventive restructuring frameworks defines the term 'restructuring' as 'changing the composition, conditions, or structure of a debtor's assets and liabilities or any other part of the debtor's capital structure, including share capital, or a combination of those elements, including sales of assets or parts of the business, with the objective of enabling the enterprise to continue in whole or in part.'

64 Articles 9-11 Proposed Directive on preventive restructuring frameworks.

65 Article 12 Proposed Directive on preventive restructuring frameworks.

66 Articles 8-11 Proposed Directive on preventive restructuring frameworks.

the latest financial crisis.[67] In most of these jurisdictions, procedures have been introduced that allow some form of restructuring.[68] Common tendencies of the procedures in some Member States several years ago already included that an arrangement that is negotiated amongst the creditors can be crammed down on a dissenting minority, and that a restructuring procedure can be started at an early stage, i.e., earlier than the moment a formal insolvency procedure can be opened.[69]

These developments beg the question if restructuring procedures under Dutch, German, and English company and general insolvency law allow (i) a cramdown in (ii) a financial restructuring outside a traditional court-centered insolvency procedure. Moreover, it raises the question if these national restructuring procedures share these two principles with the bail-in mechanism. Paragraph 4.2 investigates the first question. It shows that the domestic laws all provide for corporate restructuring procedures that are initiated by a plan proposal and end with a court confirmation that can bind dissenting creditors and shareholders to a majority vote. Only English law, however, provides for such a corporate procedure outside the context of a formal insolvency procedure, which is mainly the English scheme of arrangement procedure. In the Netherlands, a proposal for a similar procedure is pending, which is the extrajudicial plan (*onderhands akkoord*) procedure. Paragraph 4.3 then concludes that the application of the bail-in mechanism has both of the two characteristics: the resolution authority imposes a financial restructuring on the creditors and shareholders outside a traditional court-centered insolvency procedure. These conclusions about the shared principles of national corporate restructuring law and the bank resolution frameworks are further analyzed in the coherence study in chapter 7.

67 Eidenmüller & Van Zwieten 2015, p. 627; Wessels 2015c, p. 207; Wessels 2011, p. 28. *See also* Finch 2010, who notes at p. 502 that '[i]n the new millennium, governments around the world have sought, with an increasing urgency, to establish higher quality rescue processes. In the United Kingdom, for example, the Enterprise Act 2002 was passed in order to improve the insolvency procedures available to troubled corporations and to rejuvenate the broader "rescue culture".'

68 Wessels 2015c, p. 207-208.

69 Wessels 2015c, p. 208 & 210; Pieckenbrock 2012; Wessels 2007, p. 255. *See also* Commission Staff Working Document Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU (SWD(2016) 357 final, 22.11.2016), p. 15-22; De Weijs 2012, p. 74-75. Pieckenbrock's study includes the legislation in England, France, Italy, Belgium, Austria, and Germany. Other common tendencies discussed by Pieckenbrock include that the debtor can be allowed to keep control over its business, that new financing for the business is protected, and that a debt to equity swap is one of the possibilities.

4.2 Financial restructuring under national company and insolvency law

4.2.1 Corporate financial restructuring under English law

Over the last two decades, the scheme of arrangement under English company law[70] has become increasingly popular as a tool for a financial restructuring for corporate debtors, also for companies with their seat in other countries.[71] The Companies Act 2006 (CA 2006) defines it as 'a compromise or arrangement [that, LJ] is proposed between a company and (a) its creditors, or any class of them, or (b) its members, or any class of them.'[72] One of the advantages of the use of a scheme is that the CA 2006 does not require the debtor company to be insolvent, and a restructuring can, therefore, take place at an early stage of financial distress of the debtor.[73] In the scheme of arrangement procedure, the shareholders and creditors, who may include the secured creditors, are divided into and vote on the scheme in classes. Section 899 CA 2006 provides that the court may sanction the scheme if a majority in number representing 75 percent in value in each relevant class of creditors or shareholders approved it. Hence, a majority of creditors or shareholders in a class can bind a minority within the same class. Before sanctioning the scheme, the court assesses the fairness and reasonableness of the scheme, which includes, according to case law, an examination of whether the majority in the approving class fairly represented that class and that a reasonable man would approve the scheme.[74] The Act does not explicitly provide that a whole dissenting class in a scheme of arrangement procedure can be crammed down.[75] Nevertheless, according to the literature, case law suggests the court may sanction a scheme that excludes

70 Part 26 CA 2006. On 26 August 2018, the UK government announced proposals to introduce a new restructuring mechanism and moratorium. The proposals are available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG_-_Government_response_doc_-_24_Aug_clean_version__with_Minister_s_photo_and_signature__AC.pdf. These proposals will not be further discussed.

71 Eidenmüller & Van Zwieten 2015, p. 626-627; Payne 2014a, p. 175 and 188; Payne 2013, p. 564. For a discussion of the cross-border issues if a non-English company uses a scheme or arrangement under English law, *see* Payne 2014a, p. 286-324; Chan Ho 2011, p. 434-443. *See also* Sax & Swierczok 2017, p. 601-607.

72 Section 895(1) CA 2006.

73 Payne 2014a, p. 176; Payne 2013, p. 567.

74 Finch & Milman 2017, p. 410-411 refer to several cases which provide for the following summary of the role of the court: '[i]n exercising its power of sanction […] the Court will see: First, that the provisions of the statute have been complied with. Secondly, that the class was fairly represented by those who attended the meeting and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent, and, Thirdly, that the arrangement is such as a man of business would reasonably approve'. *Re Anglo-Continental Supply Company Limited* [1922] 2 Ch 723.

75 Payne 2014b, para. III, 3.

a class of creditors or shareholders and disregards their votes, and hence forces them to accept the scheme, provided that this class has 'no economic interest in the company'.[76]

For example, in the case *Re Bluebrook Ltd*[77] the restructuring proposal involved a transfer of the assets of the corporate group to newly established companies in a pre-pack administration procedure. A majority of the senior creditors agreed on schemes of arrangement to swap their claims into most of the shares in the new companies. The junior creditors and shareholders would be left behind with the old group structure that did not have any substantial assets, and they did not have the opportunity to vote on the scheme. The junior creditors challenged the schemes on the grounds of fairness. The court, however, preferred the valuation that showed that the value of the assets of the distressed companies in the group was not sufficient to cover the claims of the senior creditors. It, therefore, concluded that the junior creditors were 'out of the money'. The junior creditors had no economic interest in the company and it was appropriate to sanction the schemes.[78]

The CVA[79] forms another tool for a corporate financial restructuring under English law, whether it is as a stand-alone procedure or within an administration or winding-up procedure under the IA 1986. As is further discussed in Chapter 6, until the entry into force of the IA 1986, liquidation was considered the cornerstone of English insolvency law.[80] The CVA was introduced to promote a so-called 'rescue culture' and to enable a company to enter into an informal but binding agreement with its creditors, such as a composition of debts.[81] For the use of a CVA, the company does not have to be insolvent.[82] In contrast to a scheme of arrangement, the creditors vote as one single class on the proposed arrangement and a CVA does not result from a court order.[83] English courts also do not have powers to overrule dissenting creditors if the required majority has not consented to the CVA.[84] Furthermore, one of the limitations of the use of the CVA is that the arrangement cannot bind the secured and the preferential creditors without their consent.[85] The CVA needs to be approved by 75 percent of the creditors at the creditors' meeting and by a majority in value of the shareholders present

76 Chan Ho 2009. *Cf. In re Tea Corporation Limited* [1904] 1 Ch 12.
77 *Re Bluebrook Limited and other companies* (IMO) [2009] EWHC 2114.
78 Kornberg & Paterson 2016, para. 3.388-397; Payne 2014a, p. 43-45.
79 Part I IA 1986; Schedule A1 to the IA 1986.
80 Payne 2014b, para. III, 2.
81 Finch & Milman 2017, p. 417; Payne 2014b, para. III, 2; Tribe 2009, p. 465-466.
82 Finch & Milman 2017, p. 418; Kornberg & Paterson 2016, para. 3.246.
83 Kornberg & Paterson 2016, para. 3.246.
84 De Weijs 2012, p. 77.
85 Payne 2014b, para. III, 2. *Cf.* Section 4(3)-(4) IA 1986.

at the shareholders' meeting. Once approved, it in principle binds every creditor who was entitled to vote. Scholars note that this means that a form of cramdown within the class of creditors is possible in the procedure.[86] If the creditors but not the shareholders approve the CVA, the vote of the creditors prevails and the arrangement becomes effective, although a creditor or shareholder may then challenge the CVA in court on the grounds of unfair prejudice or material irregularity.[87]

4.2.2 Corporate financial restructuring under Dutch law

The literature has much discussed that Dutch law does not provide for an adequate statutory procedure for a corporate financial restructuring outside the formal insolvency procedures under the Fw, i.e., the bankruptcy procedure and the suspension of payments procedure.[88] These formal procedures provide the debtor and its creditor the possibility to agree on a composition plan. However, the procedures are more focused on liquidation than on a restructuring and rescue of the business. Several Dutch companies have implemented a restructuring through a scheme of arrangement under the English CA 2006.[89] The limited options for a financial restructuring outside a formal insolvency procedure that existed or exist under Dutch law are twofold.

First, until 1981 the Act on the meeting of bearer debt instruments (*Wet op de vergadering van schuldbrieven aan toonder*) provided one option to force creditors and shareholders of a corporate debtor to cooperate in a financial restructuring outside a formal insolvency procedure. Under the Act, a three-fourths majority of bondholders could take decisions in a meeting of bondholders that were binding on all bondholders.[90] Based on this Act Dutch courts allowed the conversion of bonds into shares in several cases in the first half of the twentieth century.[91]

Second, the option that still exists for a debtor is to reach an agreement with his creditors and shareholders that is governed by general rules of private law. Case law has determined that in exceptional circumstances dissenting

86 Payne 2014b, para. III, 2.
87 Sections 4a(2)-(6) and 6 IA 1986. *See* Kornberg & Paterson 2016, para. 3.254-276.
88 E.g., Vriesendorp, Hermans & De Vries 2013, para. 2.
89 Mennens & Veder 2015, para. 1.
90 *Stb.* 1934, 279.
91 Tollenaar 2008, p. 61 and *see* e.g., Rb. Amsterdam 8 February 1940, *Nederlandse Jurisprudentie* 1940/270; HR 24 June 1936, *Nederlandse Jurisprudentie* 1937/302; Hof Amsterdam 12 February 1936, *Nederlandse Jurisprudentie* 1936/496. In its decision of 12 February 1936, the Amsterdam Court of Appeal held that 'dit besluit zeer ingrijpend is voor de obligatiehouders, omdat zij bij liquidatie, dwangaccoord na surséance, of bij faillissement nog kans hebben op eenige uitkeering, terwijl zij als aandeelhouders achter de schuldeisers zullen komen.'

creditors and shareholders can be compelled to cooperate in such a case. In 2005, the Dutch Supreme Court held that dissenting creditors can be forced to agree with the measures if the rejection by these creditors constitutes an abuse of power and the creditors, therefore, could not have reasonably refused the proposed restructuring plan.[92] The fact that a dissenting creditor is aware or should be aware of the debtor's poor financial position is insufficient to conclude that the creditor misused his power. In principle, the interests of the debtor in preventing the need to open a formal insolvency procedure do not outweigh the interests of the creditor in the satisfaction of his claims out of the debtor's assets.[93] Thus, the Supreme Court set a high standard.[94] Moreover, it follows from case law that shareholders, although in principle they cannot be forced to make additional investments when a company is in dire straits,[95] under certain circumstances may have to allow a share issuance and accept a dilution of their shares and a change in the control structure.[96] The Enterprise Chamber of the Amsterdam Court of Appeal can order immediate relief measures (*onmiddellijke voorzieningen*)[97] entailing that requirements in the articles of association or statutory requirements are put aside, such as the shareholders' approval required for a capital increase, and the issuance of shares can take place if the financial situation of the company so requires.[98] Three requirements need to be met: (1) the company faces financial difficulties and its existence is threatened, (2) there is a deadlock in the decision-making within the company, and (3)

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92 HR 12 August 2005, *Nederlandse Jurisprudentie* 2006/230 (*Groenemeijer/Payroll*).

93 HR 12 August 2005, *Nederlandse Jurisprudentie* 2006/230 (*Groenemeijer/Payroll*), para. 3.5.2-3.5.4.

94 Hummelen 2016, p. 193-194; Mennens & Veder 2015, para. 2.1; Wessels 2013a, para. 6208-6240; Soedira 2011, p. 267-271. Considering the Supreme Court judgement and case law of lower courts, Wessels 2013a, para. 6240 concludes that a rejection by a creditor might be considered an abuse of power if the debtor presents his creditors a well-documented and independently reviewed offer that shows that he does his utmost to settle his debts and that in a formal insolvency procedure the creditors would receive less than under the offered plan.

95 *See* Asser/Van Solinge & Nieuwe Weme 2-IIa 2013, para. 131; Hof Amsterdam 11 March 2004, *Jurisprudentie Onderneming & Recht* 2004/190 (*Piton/Booij*), para. 4.11.

96 Draft explanatory memorandum to the *Wet Continuïteit Ondernemingen II*, 14 August 2014, available at www.internetconsultatie.nl/wco2, p. 18-19; Asser/Van Solinge & Nieuwe Weme 2-IIa 2013, para. 131.

97 Section 2:349a(2) BW.

98 Bergervoet 2015, p. 312; Draft explanatory memorandum to the *Wet Continuïteit Ondernemingen II*, 14 August 2014, available at www.internetconsultatie.nl/wco2, p. 18-19. *Cf*. Hof Amsterdam (Ondernemingskamer) 25 May 2011, *Jurisprudentie Onderneming & Recht* 2011/288; HR 25 February 2011, *Jurisprudentie Onderneming & Recht* 2011/115; Hof Amsterdam (Ondernemingskamer) 31 December 2009, *Jurisprudentie Onderneming & Recht* 2010/60 (*Inter Access*); Hof Amsterdam (Ondernemingskamer) 11 March 2004, *Jurisprudentie Onderneming & Recht* 2004/190 (*Piton/Booij*); Hof Amsterdam (Ondernemingskamer) 25 April 2002, *Jurisprudentie Onderneming & Recht* 2002/128 (*Gorillapark*); Hof Amsterdam (Ondernemingskamer) 15 November 2001, *Jurisprudentie Onderneming & Recht* 2002/6 (*Decidewise*); HR 19 October 2001, *Jurisprudentie Onderneming & Recht* 2002/5 (*Skygate*).

there is no alternative solution available than the issuance of new shares.[99] In this way, conversion of a loan into shares in the company may be effectuated even though a major shareholder rejected the proposed plan.[100] Hence, only in specific circumstances, the continued existence of the company may outweigh the interests of a major shareholder in retaining a certain degree of control in the company.[101]

On 5 September 2017, the draft bill for the Act on Court Confirmation of Extrajudicial Restructuring Plans to Avert Bankruptcy (*Wet Homologatie Onderhands Akkoord ter Voorkoming van Faillissement,* WHOA) was published.[102] The approach taken in the draft bill is to introduce a statutory procedure in the Fw to bind shareholders and creditors, including the preferential and the secured creditors, to a restructuring plan (*akkoord*) outside a bankruptcy or suspension of payments procedure.[103] Scholars note that the proposed procedure fits well with the 'corporate rescue tendency in the international insolvency law' ('*corporate rescue-tendens in het internationale insolventierecht*').[104] The Ministry of Justice and Security based the draft bill partly on the English provisions on the scheme of arrangement.[105]

If the draft bill is passed in its current form and similar to the English scheme of arrangement, for the restructuring plan to be offered there is no requirement that the debtor company is insolvent.[106] Furthermore, the draft bill does not limit the possible content of the plan, the affected creditors and shareholders vote in classes, and the stakeholders are bound to the restructuring plan once the court confirms it.[107] Unlike the English CA 2006 regarding the scheme of arrangement, the draft bill explicitly provides that with the confirmation of the Dutch restructuring plan not only a so-called 'intra-class cramdown' but also a 'cross-class cramdown' can take place.[108] That is,

99 Bergervoet 2015, p. 312-313; Doorman 2010, para. 3. *Cf.* De Kluiver 2006, p. 21.
100 *Cf.* Hof Amsterdam (Ondernemingskamer) 31 December 2009, *Jurisprudentie Onderneming & Recht* 2010/60 (*Inter Access*); HR 25 February 2011, *Jurisprudentie Onderneming & Recht* 2011/115.
101 Bergervoet 2015, p. 312-313; Draft explanatory memorandum to the *Wet Continuïteit Ondernemingen II*, 14 August 2014, available at www.internetconsultatie.nl/wco2, p. 18; Asser/Van Solinge & Nieuwe Weme 2-IIa 2013, para. 131.
102 The draft bill is available at https://www.internetconsultatie.nl/wethomologatie.
103 Section 369 et seq. Fw.
104 Mennens & Veder 2015, para. 5.
105 *Cf.* Vriesendorp, Hermans & De Vries 2013.
106 Sections 370-371 Fw provide that a debtor can offer a restructuring plan if he 'anticipates that he will be unable to continue paying his due and payable debts' and a creditor can initiate the offering of the plan if it is 'reasonably likely that a debtor will be unable to continue paying his debts'.
107 Sections 373-374 and 381-382 Fw.
108 *See* De Brauw Blackstone Westbroek, response in the consultation on the Draft Bill on the WHOA of 30 November 2017, available at www.internetconsultatie.nl/wethomologatie/reacties, p. 7-8. *Cf.* Sections 380(1), 381(1) and (4) Fw.

the plan may not only bind dissenting creditors or shareholders within the same class but also a whole dissenting class or classes. A class approves the plan if the creditors or shareholders in the class representing at least two-thirds of the total value of the claims or issued capital, respectively, held by the class vote in favor of the plan.[109] If one or more classes vote against the restructuring plan, the court can declare the restructuring plan binding on all creditors and shareholders who were entitled to vote. However, in this case, safeguards for the shareholders and creditors apply.[110] The court may decide to refuse confirmation, for example, if creditors or shareholders in a dissenting class receive less under the plan than they would receive in a bankruptcy procedure or if they are not fully repaid while a lower ranking group receives or retains rights under the restructuring plan.[111]

4.2.3 Corporate financial restructuring under German law

Three different German legal frameworks can govern a restructuring of the right side of the balance sheet of a non-financial corporate debtor: company law, the Bond Act (*Schuldverschreibungsgesetz*) and insolvency law.[112] A pre-insolvency procedure that can be used for a financial restructuring and is similar to the English scheme of arrangement and the proposed Dutch extrajudicial restructuring plan procedure does not exist under German law.

Firstly, the German Stock Corporation Act (*Aktiengesetz*, AktG) offers several measures that can be used for a financial restructuring outside a formal insolvency procedure under the InsO. These include a reduction of the share capital to compensate for a decline in the value of assets[113] and a share capital increase by issuing new shares.[114] The AktG requires a decision of a majority of at least three-fourths of the share capital represented at the shareholders' meeting for such a capital decrease and increase.[115] These requirements entail that the shareholders can, in principle, easily block important restructuring decisions and have been widely considered a major hurdle in restructuring procedures.[116]

109 Section 378(4)-(5) Fw.

110 Section 381 Fw also provides for several safeguards for dissenting creditors and shareholders in a class which approved the plan. Under Section 381(3) Fw the court does not confirm the plan if, for example, a creditor or shareholder receives less under the plan than he would receive in a bankruptcy procedure.

111 Section 381(4) Fw.

112 *See* Häfele 2013, p. 42-46.

113 For a discussion of a capital reduction under the AktG as a balance sheet restructuring ('*Buchsanierung*'), *see* HüfferKomm-AktG/Koch 2016, Sections 222 and 229; Häfele 2013, p. 49-53; Von Jacobs 2010, p. 80-88; Wirth 1996, para. 3.

114 Section 182 AktG. *See* HüfferKomm-AktG/Koch 2016, Section 182; Bork 2012a, para. 15.05.

115 Sections 182, 222 and 229 AktG.

116 Bork 2012a, para. 5.06 and 15.06; Schuster 2010; Von Jacobs 2010, p. 83.

However, the German Federal Court of Justice has recognized a shareholder's duty of loyalty (*Treuepflicht*) in relation to the company and the other shareholders, which may require shareholders to consider the interests of the company.[117] In *Girmes*,[118] for instance, the Court held that the duty of loyalty amongst shareholders prevented the minority shareholders from blocking a decision on a capital reduction for selfish motives. The decision had the support of the majority and might have saved the company from insolvency in which the shareholders were in a worse economic position. This does not entail, however, that shareholders are always required to vote in favor of restructuring measures.[119] The literature considers the case a special case and argues that the duty cannot be used as a basis for a restructuring procedure.[120] Regarding the cooperation of creditors in a restructuring outside an insolvency procedure, the Federal Court of Justice ruled in a leading decision that a creditor cannot be forced to agree with debt restructuring measures because the majority of the creditors agrees with the measures. It would infringe constitutional property rights. In this case, the debt restructuring measure was a claim reduction. The case in literature often referred to as the 'arrangement disturber' (*Akkordstörer*) decision.[121]

Secondly, the Bond Act (*Gesetz über Schuldverschreibungen aus Gesamtemissionen*) also facilitates a financial restructuring. Under the Bond Act the terms and conditions of bonds issued under German law may allow a majority of the bondholders to force the other bondholders to accept a modification of the terms and conditions.[122] Thus, the scope of application of the Act is limited to bonds. Possible measures are, for instance, a reduction of the principal amount due, a subordination of the claims, and conversion of the bonds into shares.[123]

Thirdly, the InsO provides for a formal insolvency procedure in which a company can enter into a binding restructuring plan with its creditors and shareholders, which is the insolvency plan procedure. Under section 270b InsO the court can first open a so-called protective shield procedure (*Schutzschirmverfahren*) in which an imminently illiquid or over-indebted

117 Bundesgerichtshof 19 October 2009, II ZR 240/08, BGHZ 183,1 (*Sanieren oder Ausscheiden*); Bundesgerichtshof 20 March 1995, II ZR 205/94, BGHZ 129, 136 (*Girmes*).

118 Bundesgerichtshof 20 March 1995, II ZR 205/94, BGHZ 129, 136 (*Girmes*).

119 Häfele 2013, p. 80-86; Bork 2012a, para. 5.06; Schuster 2010, p. 332-335; Westpfahl 2010, p. 397-399. *See also* Madaus 2011.

120 Bork 2012a, para. 5.06; Schuster 2010, p. 332-335.

121 Bundesgerichtshof 12 December 1991, IX ZR 178/91, BGHZ 116, 319 (*Akkordstörer*). *See* Bitter 2010, p. 167-169; Westpfahl 2010, p. 395-397. For a discussion of a new system with duties for creditors to cooperate in restructuring cases which is developed by Eidenmüller, *see* Eidenmüller 1999, Chapter 6.

122 Sections 4-22 Bond Act. *See* Thole 2014, p. 2365-2368; Häfele 2013, p. 44-46.

123 Section 5(3) Bond Act. Under Article 5(4) Bond Act most of the measures require a majority of at least 75 percent of the relevant bondholders.

company has a few months to work out an insolvency plan under the supervision of a preliminary administrator (*Sachwalter*). This procedure entails that restructuring measures in an insolvency plan can already be prepared before a formal insolvency procedure may subsequently be opened.[124] For the financial restructuring to take place, the court has to open an insolvency procedure. This has been criticized in literature.[125]

The InsO explicitly provides that an insolvency plan in an insolvency plan procedure can include financial restructuring measures such as the conversion of creditors' claims into shares, decrease or increase of share capital, and exclusion of pre-emption rights.[126] The insolvency plan needs to be approved by affected creditors and shareholders and confirmed by a court.[127] In the past, restructuring measures affecting shareholders' rights could only be implemented in an insolvency plan procedure with the consent of the shareholders as required under company law, which was considered a major hurdle in restructuring procedures.[128] In 2012, German insolvency law was amended to facilitate corporate restructurings.[129] The InsO now provides that shareholders are party to the insolvency plan procedure and, where relevant, shareholder resolutions required for certain

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124 For a critical discussion of the procedure under Section 270b InsO, *see* Madaus 2012, p. 104-107.

125 E.g., Madaus 2017, p. 333, who concludes that: '[e]ine formelle Insolvenz lässt sich auf diesem Wege nicht vermeiden. Damit kauft man sich all die negativen Folgen einer – auch nur kurzen – Verfahrenseröffnung ein. Insbesondere für Unternehmensgruppen enden die Beherrschungsverträge bzw. die Beherrschungsmöglichkeiten und eine allenfalls koordinierte Verfahrensabwicklung nach dem jeweiligen Konzerninsolvenzrecht tritt an deren Stelle. Aber auch bei nicht konzerngebundenen Unternehmen kommt es zu den negativen Folgen eröffneter Insolvenzverfahren im Hinblick auf Covenants in Finanzierungs- und Lieferverträgen oder aber auch auf Kundenbeziehungen und Imagepflege. Insgesamt ist die Option Schutzschirm mithin nicht geeignet, um noch relativ gut finanzierten Unternehmen bei Akkordstörerproblemen zu helfen. Zugleich bietet die Mehrheitsmacht in § SCHVG § 5 SchVG nur eine Option für Anleiherestrukturierungen, nicht aber ein Instrument für sämtliche Formen finanzieller Restrukturierungen. Eine auf diese konkrete Problemstellung fokussierte vorinsolvenzliche Sanierungshilfe fehlt dem deutschen Recht.'

126 Section 225a(2) InsO.

127 Sections 244-248 and 254 InsO.

128 Kleindiek 2012, p. 545; Spetzler 2010, p. 434-437; Eidenmüller & Engert 2009, p. 542-543 and 549; Piekenbrock 2009, p. 268-270. According to the German legislature, the strict separation between company law and insolvency law needed to be abandoned to facilitate the application of capital restructuring measures within an insolvency plan procedure, in particular, the conversion of creditor claims into shares. Gesetzentwurf der Bundesregierung, Entwurf eines Gesetzes zur weiteren Erleichterung der Sanierung von Unternehmen, Deutscher Bundestag, Drucksache 17/5712, 4 May 2011, p. 18.

129 *See* Gesetzentwurf der Bundesregierung, Entwurf eines Gesetzes zur weiteren Erleichterung der Sanierung von Unternehmen, Deutscher Bundestag, Drucksache 17/5712, 4 May 2011, p. 17. The InsO was amended by the Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen (ESUG) of 7 December 2011, Federal Law Gazette (Bundesgesetzblatt) 2011, Part I, p. 2582-2591.

measures under company law are deemed to have been adopted if the insolvency plan has been agreed on.[130] Shareholders and creditors vote in different classes and can be forced to accept the insolvency plan if a majority by vote and value in their class agrees with the proposal. Also, a 'cross-class cramdown' is possible under the InsO. However, German scholars have been very reluctant to accept the introduction these amendments to the insolvency plan procedure that aim to facilitate that dissenting shareholders of the company can be bound to the measures and, as a result, their rights modified.[131] The InsO now aims to protect creditors and shareholders with the requirements that if a class has not accepted the proposal, the dissent of creditors can only be replaced by a court decision if (1) the members of the class are not placed in a worse position than without the plan, (2) they participate to a reasonable extent in the economic value devolving on the parties under the plan,[132] and (3) at least a majority of all classes has approved the proposal.[133] Moreover, conversion of claims into shares cannot take place against the will of the relevant creditors.[134]

4.3 Financial restructuring under the bank resolution rules

Because the bail-in mechanism gives resolution authorities far-reaching powers to impose losses on creditors and shareholders and convert certain claims into shares, the literature considers it the 'innovative Herzstück der BRRD',[135] a 'Wunderwaffe'[136], 'the most controversial weapon among the guns in the [BRRD, LJ] arsenal'[137] and 'the most significant regulatory achievement in post-crisis efforts to end "Too Big To Fail"'.[138] It is the present author's view, however, that the substantive effect of the measures may not be very different from the effect of a financial restructuring for other types of businesses. As is further discussed below, the most important difference is that an administrative authority has discretionary powers to implement the financial restructuring by regulatory decision.[139]

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130 Sections 217 and 254a(2) InsO. *See* UhlenbruckKomm-InsO/Luër/Streit 2015, Section 254a, para. 6-11; Kleindiek 2012, p. 546.

131 E.g., Madaus 2011.

132 *Cf.* Section 245(2)-(3) InsO.

133 Section 245 InsO. *See* Gesetzentwurf der Bundesregierung, Entwurf eines Gesetzes zur weiteren Erleichterung der Sanierung von Unternehmen, Deutscher Bundestag, Drucksache 17/5712, 4 May 2011, p. 18; Thole 2014, p. 2370-2372; MünchKomm-InsO/Drukarczyk 2014, Section 245, para 14-101.

134 Sections 225a(2) and 230(2) InsO. *See* Schwarz 2015, p. 234-236; MünchKomm-InsO/Eidenmüller 2014, section 230, para. 44-70.

135 Adolff & Eschweg 2013, p. 962, also cited by Binder 2015a, p. 120.

136 Thole 2016, p. 67.

137 Bliesener 2013, p. 191.

138 Ringe 2018, p. 3.

139 Schillig 2018, para. 3.2.

Similar to the developments in corporate restructuring and insolvency law to facilitate the implementation of a financial restructuring where there is a 'likelihood of insolvency', bail-in takes place outside a traditional, court-centered insolvency procedure and preferably also at an early stage of financial difficulties. For example, the resolution authorities can exercise the write-down or conversion of capital instruments and eligible liabilities tool already before any resolution action is taken.[140] As indicated in chapter 2,[141] a bank resolution procedure in which the bail-in tool can be applied can be opened when the resolution conditions are met, which conditions include the condition that a bank has crossed the 'failing or likely to fail' threshold. This condition is satisfied if the bank is expected to be failing in the 'near future', for instance, because the bank is likely to infringe soon the requirements for continuing authorization in a way that would justify the withdrawal of the authorization, such as the own funds requirements.[142] The SRM Regulation confirms that the resolution procedure should preferably be opened at an early stage of failure. Its recitals explicitly state that '[t]he decision to place an entity under resolution should be taken before a financial entity is balance sheet insolvent and before all equity has been fully wiped out.' [143]

Furthermore, the bail-in mechanism is a financial restructuring mechanism that can be used to force creditors and shareholders to accept the restructuring measures, although not through an arrangement between the debtor and a certain percentage of its creditors and shareholders and confirmed by a court, but by administrative decision.[144] The resolution authority decides on the application of the write-down and conversion powers. Article 53(1) BRRD explicitly provides that the exercise of the bail-in powers takes effect and is immediately binding on the bank and affected creditors and shareholders. Hence, it is not a cramdown of a dissenting minority in a class or one or more dissenting classes, as may be the case in a financial restructuring under national company and insolvency law, but of all creditors and shareholders. German legal scholars have considered the introduction of the bail-in mechanism in the SAG 'revolutionary', mainly because the literature has extensively discussed whether an infringement of rights of shareholders in an insolvency plan procedure under the InsO is in line with the constitutional protection of these rights under German law. Surprisingly, the introduction of the bail-in mechanism has not been as fiercely debated in the literature as was the amendment to the InsO under which dissenting shareholders can be directly bound to an insolvency plan.[145]

140 Article 59(3) BRRD; Article 21(1) SRM Regulation. *See* paragraph 3 above.
141 Paragraph 3.2.1 of chapter 2.
142 Article 32(1) and (4) BRRD.
143 Recital 57 SRM Regulation.
144 De Weijs 2013, p. 219.
145 Burkert & Cranshaw 2016, p. 450.

The role of the stakeholders in a corporate financial restructuring is different than in bail-in. In contrast to the bail-in procedure, in a corporate financial restructuring there are typically negotiations and the decision reflects the commercial judgement of the stakeholders. Two arguments can be put forward as to why the financial restructuring in a bank resolution procedure is largely taken out of the hand of the creditors, shareholders, and court and implemented by an administrative authority. These arguments tie in with the reasoning discussed in chapter 2 of why special rules for bank failures should exist. Firstly, the use of a court to play an oversight role in the procedure and allowing creditors and shareholders to negotiate and reach an agreement on the restructuring is time-consuming. It is an accepted view in the EU that administrative authorities are better suited to manage a bank resolution procedure and take the necessary proactive decisions in the public interest because they can act quickly without the need for lengthy negotiations.[146] As we saw already in chapter 2,[147] in a bank failure time is often of the essence to prevent a further weakening of the financial position of the bank, and a spread of the financial problems to other parts of the financial system. Secondly, even if creditors and shareholders are allowed to negotiate on a restructuring plan, the majorities required in a corporate financial restructuring procedure under insolvency law may not be reached. As stated in chapter 2[148] and paragraph 2.2 of this chapter, creditors and shareholders are expected to seek to disrupt the restructuring by not approving the proposed measures. They may speculate that the government will never let the bank fail and will be forced to provide public financial support instead.[149] The intervention by an administrative authority is therefore needed, so the argument goes, to bind all shareholders and creditors to the necessary restructuring measures.[150] Accordingly, from a corporate restructructuring and insolvency law perspective, this authority may need to be regarded to act as a party in which hands all individual rights are brought together and which has much discretionary power to take decisions and manage the procedure.[151]

146 *See* e.g., Haentjens 2016, p. 24-25; Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (SWD(2012) 166 final, 6.6.2012), p. 11, stating that '[i]nsolvency procedures may take years' and that '[b]ank resolution […] ensures that decisions are taken rapidly in order to avoid contagion.' *See also* Cassese 2017, p. 244, who argues that 'courts are reactive (they act upon request of a party) and not proactive, while modernized resolution procedures require preventive measures to avoid insolvency.'

147 Paragraph 2.2.1 of chapter 2.

148 Paragraph 2.2.1 of chapter 2.

149 De Weijs 2013, p. 217-221.

150 Schillig 2016, p. 65-66; De Weijs 2013, p. 217-221.

151 Schillig 2018, para. 3.2; Schillig 2016, p. 66.

5 Implementation of the bail-in rules into national law

5.1 Effects of a reduction of liabilities

5.1.1 Introduction

This paragraph further investigates the implementation of the bail-in framework in Dutch, German, and English law. It questions what kind of liabilities fall within the scope of the bail-in powers, and what is the effect of bail-in on the debt of the bank and related guarantees under national law.

5.1.2 Definition of the term 'liabilities'

We saw in paragraph 3 of this chapter that under the BRRD bail-in is conducted by writing-down and converting a bank's so-called 'relevant capital instruments' and 'bail-inable liabilities'. Relevant capital instruments are AT1 instruments and T2 instruments under the CRR.[152] Bail-inable liabilities are capital instruments and liabilities that do not qualify as CET1, AT1 and T2 instruments and are not excluded from the scope of bail-in under article 44(2) BRRD.[153] As paragraph 5.3 below discusses in more detail, excluded liabilities are, inter alia, liabilities that are fully secured and deposits up to the amount covered by a deposit guarantee scheme. The BRRD also gives the resolution authorities the power to exclude or partially exclude other types of liabilities in exceptional circumstances.[154]

The BRRD does not provide what exactly are 'liabilities' that qualify as bail-inable liabilities. Hence, it seems to give resolution authorities some discretion in their assessment what is to be bailed-in to restructure the balance sheet of a bank.[155] The bail-in rules do require the authorities, however, to allocate the losses equally between capital instruments and liabilities of the same rank and not to bail-in one class of bail-inable liabilities if a more junior class remains substantially unconverted or not written down.[156]

152 Article 2(1)(74) BRRD.

153 Article 2(1)(71) BRRD. Before entry into force of the recent amendments to the BRRD, these liabilities were called 'eligible liabilities'. The term 'eligible liabilities' is now used for debt that counts towards the MREL under articles 45-45k BRRD. *See* paragraph 3 of this chapter.

154 Article 44(2)-(3) BRRD.

155 *Cf*. Recital 70 BRRD, which states that 'in order to ensure that the bail-in tool is effective and achieves its objectives, it is desirable that it can be applied to as wide a range of unsecured liabilities of a failing institution as possible.'

156 Article 48(2) and (5) BRRD. *See also* paragraphs 3 and 5.3 of this chapter, which explain that the bail-in mechanism has to be applied in a certain order. As discussed in paragraph 5.3, a recently enacted EU directive requires Member States to create a class of non-preferred senior bank debt, which can be bailed-in after regulatory capital and (other) subordinated liabilities but before senior liabilities.

It is the present author's view that the term 'liabilities' should be interpreted broadly to include all contractual and non-contractual payment obligations of the bank that have arisen before the implementation of the resolution measures. The definition of the term in the rules of the UK PRA that implement article 55 BRRD seems to support this view. Article 55 BRRD requires banks to include in their non-EEA law governed contracts a clause by which the creditor or party to the agreement creating the liability recognizes that the liability may become subject to bail-in.[157] According to the PRA Rulebook, 'liability' means in this context 'any 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.'[158] The PRA notes that it aligned this definition with the definition of 'provable debts' in English insolvency law, which provides that 'in a bank insolvency all claims by creditors are provable as debts against the bank, whether they are present or future, certain or contingent, ascertained or sounding only in damages.'[159] Under this definition, a resolution authority has to power to bail-in all liabilities that are not excluded liabilities, whether they are, for instance, liabilities under a debt instrument that are payable in the future, contingent liabilities such as liabilities under guarantees that can transform into payment obligations, liabilities for breach of contract, or liabilities in tort. According to the present author, the definition provided by the PRA can also be used to interpret the terms 'passiva' and 'Verbindlichkeiten', which are not defined in part 3a Wft and the SAG, respectively.

5.1.3 Effects of the reduction

Write-down and conversion are in the BRRD together referred to as 'reduction'.[160] Article 53(3) BRRD provides what is the effect of a full reduction of a bank's liability.[161] It uses the term 'principal amount of a liability', which should according to the European Commission be interpreted as the original sum owed or the remaining part thereof. The provision also contains the term 'outstanding amount payable in respect of a liability',

157 *See* Rank & Uiterwijk 2016.

158 PRA Rulebook, CRR Firms, Contractual Recognition of Bail-in, section 1.2.

159 Rule 262 Bank Insolvency (England and Wales) Rules 2009 (SI 2009/356), as referred to in Prudential Regulation Authority, 'The contractual recognition of bail-in: amendments to Prudential Regulation Authority Rules', June 2016, p. 8. *Cf.* Rule 14.2(1) Insolvency (England and Wales) Rules 2016/1024, providing that '[a]ll claims by creditors except as provided in this rule, are provable as debts against the company or bankrupt, whether they are present or future, certain or contingent, ascertained or sounding only in damages.' and rule 14.1(3), Insolvency (England and Wales) Rules 2016/1024, defining the term 'debt' in winding-up and administration as '(a) any debt or liability to which the company is subject at the relevant date; (b) any debt or liability to which the company may become subject after the relevant date by reason of any obligation incurred before that date; (c) any interest provable as mentioned in rule 14.23.'

160 *Cf.* e.g., Article 48(1) BRRD.

161 *Cf.* Article 63(1)(e) BRRD.

which may include other elements such as accrued interest on the principal amount up to the date on which the resolution measures are triggered.[162] If a resolution authority reduces the principal amount of or outstanding amount payable in respect of a liability to zero,

> 'that liability and any obligations or claims arising in relation to it that are not accrued at the time when the power is exercised shall be treated as discharged for all purposes, and shall not be provable in any subsequent proceeding in relation to the institution under resolution or any successor entity in any subsequent winding-up.'

If the resolution authority reduces the principal or outstanding only in part, under article 53(4) BRRD the liability is treated as discharged to the extent of the amount reduced. The relevant instrument or agreement that created the original liability continues to apply in relation to the residual amount of or outstanding amount payable in respect of the liability. Article 60 BRRD provides that if the resolution authority applies the write-down or conversion of capital instruments and eligible liabilities tool, the effect of the reduction is permanent and

> 'no liability to the holder of the relevant capital instrument shall remain under or in connection with that amount of the instrument, which has been written down, except for any liability already accrued, and any liability for damages that may arise as a result of an appeal challenging the legality of the exercise of the write-down power'.

It is the present author's view that articles 53 and 60 BRRD aim to ensure that bail-in of a capital instrument or liability releases the bank by operation of law from this debt. Under Dutch law, the effect on the liability of the bank is to be considered equivalent to the effect of a remission (*kwijtschelding*) of a debt under section 6:160 BW and under German law equivalent to the effect of a remission (*Erlass*) of a debt under section 397 Bürgerliches Gesetzbuch (BGB). Hence, the obligation is terminated.[163] Under English law, discharge of liabilities by operation of law can also take place, for instance, if it is a discharge of liabilities of a bankrupt individual under sections 279-280 IA 1986. The effect of such discharge by operation of law is also the release of the debtor from the debt.[164]

Following bail-in, a resolution authority may write-up (increase) the value of claims of creditors and holders of capital instruments which it has written down if the final resolution valuation shows that the level of write-down

162 European Commission, Q&A Bank Recovery and Resolution Directive, January 2015, Article 43 BRRD.
163 *Cf.* Asser/Sieburgh 6-II 2017, para. 312; MüKoBGB/Schlüter 2016 section 397, para. 7.
164 *See* Fletcher 2017, para. 11.009.

should be less than has taken place.[165] DNB has noted that it means that a part of the claims then 'revives' by operation of law at its original terms and conditions to reimburse the relevant creditors and shareholders.[166] The BRRD and SRM Regulation only explicitly provide for this possibility after a write-down.[167] It is the present author's view that one should interpret the term 'write-down' in this provision as also including conversion so that the value of claims which have been converted into equity can also be increased. Creditors whose claims are affected by conversion into equity may also be appropriated more equity value as compensation if the final valuation shows that the net asset value of the bank is higher than the value according to the provisional valuation.[168] In contrast to the reduction of a liability under articles 53 and 60 BRRD, the write-up of the debt by the resolution authority does not seem to have an equivalent provision in national private law.

According to the present author, it is unclear what is the scope of the phrase 'any obligations or claims arising in relation to it' in article 53(3) BRRD.[169] The wording of the provision suggests that it includes a right of a guarantor to be indemnified by the bank as principal debtor for payments made under a guarantee to a creditor of the bank. This is especially suggested by the phrase 'shall not be provable in any subsequent proceeding in relation to the institution under resolution or any successor entity'. Article 44(2) BRRD explicitly excludes liabilities of the bank that are fully secured from the scope of bail-in. This exclusion covers only *in rem* security arrangements and does not cover liabilities of the bank secured by personal security such as a guarantee of a group company or a third party.[170] It would mean that following bail-in, under article 53(3) BRRD both the principal claim and the indemnity claim against the bank are treated as discharged by operation of law. This effect seems sensible because bail-in of the principal liability owed to the creditor may not provide a solution for the financial problems of the bank if the guarantor then has a claim against the bank.[171]

165 Article 46(3) BRRD; Article 20(12) SRM Regulation.
166 De Nederlandsche Bank, 'Operation of the bail-in tool', December 2017, p. 10.
167 Article 46(3) BRRD; Article 20(12) SRM Regulation.
168 *Cf*. Article 50 BRRD.
169 The literature has not devoted much attention to the meaning of Article 53(3) BRRD. *But see* Schillig 2016, p. 295-296, who also discusses that the meaning of the provision in not entirely clear.
170 Article 2(1)(67) BRRD defines the term 'secured liability' as 'a liability where the right of the creditor to payment or other form of performance is secured by a charge, pledge or lien, or collateral arrangements including liabilities arising from repurchase transactions and other title transfer collateral arrangements.' *See also* European Banking Authority, Single Rulebook Q&A, no. 2015/1779, Article 44 BRRD.
171 Schillig 2016, p. 295-296.

Article 53(3) BRRD does not exclude the possibility that 'any obligations or claims arising in relation to it' also include a claim of a bank's creditor under a guarantee. If this is the case, a creditor may lose both his claim against the bank and his claim against a guarantor who promised to indemnify the creditor for losses resulting from the default of the bank as principal debtor. In case of conversion of a claim of a creditor into equity, the creditor may still have a claim against the guarantor for the amount that is left after a deduction of the value of the equity claim from the value of the claim under the guarantee.[172] If the mentioned phrase does not cover a claim of a bank's creditor under a guarantee, it depends on the provisions in the guarantee agreement and on national private law whether a discharge of the principal debt claim by operation of law results in a release of the guarantee liability.

Section 3a:25 Wft copies article 53(3) and (4) BRRD, although without the phrases 'for all purposes' and 'and shall not be provable in any subsequent proceeding in relation to the institution under resolution or any successor entity'.[173] Hence, the provision does not provide any clarification regarding the scope of the phrase 'any obligations or claims arising in relation to it'. It is the present author's view that section 3a:25 Wft and article 53(3) and (4) BRRD only aim to ensure that if an authority reduces a bank's liability, the bailed-in (part of the) debt can no longer be collected from this bank. The provisions do not aim to interfere in the relationship of a creditor and another party and do not require that a claim of this creditor against the other party is also treated as discharged by operation of law.[174]

One possible interpretation of section 3a:25 Wft then is that following bail-in of a bank's liability a creditor has a claim against a surety (*borg*) under section 7:855(1) BW because the bank does not pay off his debts because his liability was bailed-in. Thus, the bank has failed to perform its obligations. Under section 7:855(1) BW, a surety is liable after the principal debtor has made default.[175] The indemnity claim of the surety against the bank may then be treated as discharged under section 3a:25 Wft, as discussed above.

172 *See* De Serière 2014, p. 176.

173 Section 3a:25(1) Wft provides in English that 'Notwithstanding article 3a:25a, if the Dutch Central Bank reduces to zero the principal amount of or outstanding amount payable in respect of a liability under article 3a:21, first paragraph, that liability and any obligations or claims arising in relation to it that are not accrued at the time when the power is exercised shall be treated as discharged.' It is the present author's view that the phrase 'for all purposes' is vague. The insertion of the phrases 'for all purposes' and 'shall not be provable in any subsequent proceeding in relation to the institution under resolution or any successor entity' would not make any relevant difference for the meaning of section 3a:25(1) Wft.

174 *Contra* Schillig 2016, p. 295, who holds the view that under Article 53(3) BRRD also the claim under a guarantee is treated as discharged.

175 Section 7:855(1) BW reads in Dutch: '[d]e borg is niet gehouden tot nakoming voordat de hoofdschuldenaar in de nakoming van zijn verbintenis is tekort geschoten.'

The creditor may also still have a claim against a co-debtor who is jointly and severally liable (*hoofdelijk mede-schuldenaar*) under section 6:6 BW.

This interpretation of section 3a:25 Wft corresponds to section 160 Fw on the composition in a bankruptcy procedure.[176] According to case law, a bankruptcy composition that is sanctioned by the court under sections 153 and 157 Fw has a limited effect. It only denies the enforceability of the parts of the claims against the insolvent debtor that remain unpaid. These parts become a natural obligation (*natuurlijke verbintenis*).[177] The fact that the remaining claims cannot be enforced at law does not entail, however, that the claim a creditor has against a surety or co-debtor of the insolvent debtor also becomes unenforceable. Section 160 Fw provides that the bankruptcy composition does not affect the latter claim.[178] Thus, a surety remains fully liable to the creditor under a suretyship guarantee if the principal debtor's liability to the creditor is reduced (the creditor gives discharge) under the composition. The section provides an exception to section 7:851(1) BW, under which the obligation of the surety is accessory to the obligation of the principal debtor and to section 6:7(2) BW, which provides that the settlement of the obligation by one of the co-debtors who are jointly and severally liable also discharges the other co-debtor against the creditor.

It is questionable, however, whether the above-mentioned interpretation of section 3a:25 Wft is correct. The Dutch legislature introduced section 160 Fw to provide for a statutory exception to the normally accessory nature of the claim against a surety or co-debtors who are jointly and severally liable. Since Part 3a Wft does not provide for an equivalent rule, it is questionable that an exception that is similar to the exception in section 160 Fw applies.

Another possible interpretation of section 3a:25 Wft and according to the present author the better view is that following bail-in the surety is no longer liable to the creditor and the co-debtor no longer for the joint and several obligation (*hoofdelijke verbintenis*). The bank's liability which the surety guaranteed in accordance with sections 7:850 et seq. BW and for which the co-debtor was jointly and severally liable under section 6:6(2) BW is treated as discharged. As indicated above, section 7:851(1) BW explicitly provides that the obligation of the surety is accessory to the obligation of the principal.

176 Under section 272(5) Fw, section 160 Fw also applies to a composition in a suspension of payments procedure (*surseance-akkoord*).

177 HR 31 January 1992, *NJ* 1992, 686 (*Van der Hoeven/Comtu*). *See* Bergervoet 2014, para. 96.

178 For a discussion of section 160 Fw, *see* Bergervoet 2014, para. 96; Wessels 2013a, para. 6021-6023; Soedira 2011, p. 191-195. *Cf.* Sections 369(7) and 370(2) Fw, which are part of the draft bill on the extra judicial restructuring plan procedure and provide that a claim of a creditor against a third party such as a guarantor or an indemnity claim of a third party against the debtor can be included in a restructuring plan. On the procedure, *see* paragraph 4.2.2 of this chapter.

Thus, in this view, the surety is discharged from his obligation because of the discharge of the bank from its liability by operation of law under Part 3a Wft. The legislative history of Part 3a Wft confirms this view. It notes that if a parent company has issued a so-called '403 statement' (403-*verklaring*) and the resolution authority bails-in its subsidiary's liabilities, a creditor cannot seek recourse against the parent company under section 6:6(2) BW.[179] In a 403 statement the parent company assumes joint and several liability for certain debts of its subsidiaries in accordance with section 2:403 BW. According to the parliamentary notes, a creditor cannot seek recourse against the parent company in such a case because the subsidiary is discharged from its liability.[180] The position of a guarantor may be different if the guarantee agreement is structured as an independent guarantee (*onafhankelijke garantie*) and the creditor beneficiary is entitled to payments on first demand and without evidence of the size of his loss. In such a case, the obligation of the guarantor is typically independent of that of the obligor and the beneficiary is entitled to receive payments in accordance with the terms of the guarantee.[181]

German law and English law seem to have their own approaches to the possible effects of a debt reduction.

The SAG incorporates article 53(3) and (4) BRRD into German law by transposing a concept of the insolvency plan procedure provided by section 254(2) InsO. According to the latter provision:

> '[d]ie Rechte der Insolvenzgläubiger gegen Mitschuldner und Bürgen des Schuldners sowie die Rechte dieser Gläubiger an Gegenständen, die nicht zur Insolvenzmasse gehören, oder aus einer Vormerkung, die sich auf solche Gegenstände bezieht, werden durch den Plan nicht berührt. Der Schuldner wird jedoch durch den Plan gegenüber dem Mitschuldner, dem Bürgen oder anderen Rückgriffsberechtigten in gleicher Weise befreit wie gegenüber dem Gläubiger.'[182]

Similarly, section 99(8) SAG provides that a write-down or conversion of a bank's liability does not affect the rights the involved creditors may have against the debtor's co-debtor (*Mitschuldner*), a surety (*Bürge*) or any other

179 Explanatory Notes to the Draft BRRD Implementation Act (*Kamerstukken II* 2014/15, 34208, no. 3), p. 93-94.

180 Explanatory Notes to the Draft BRRD Implementation Act (*Kamerstukken II* 2014/15, 34208, no. 3), p. 94, discussing that in practice in most cases the banking group as a whole and not only the subsidiary will be made subject to resolution.

181 *See* Russcher 2018.

182 Translation by the present author: the plan does not affect the rights the insolvency creditors have against the co-obligors and guarantors of the debtor as well as the rights of these creditors to objects that are not part of the insolvency estate or deriving from a priority notice covering those objects. The debtor shall be discharged under the plan of the claims against himself of the co-obligors, guarantors or any other redressing party in the same way as he is discharged of the claims of the insolvency creditors.

party who is liable for the debtor's obligations (*sontige Dritte*).[183] Thus, the claims against these third parties remain to exist.[184] Section 99(8) SAG provides for an exception to the normally accessory nature of the suretyship (*Bürgschaft*), comparable to section 254(2) InsO.[185] To fully achieve the intended effects of the reduction, under section 99(8) SAG the bank's obligation in relation to the mentioned third parties is treated as discharged to the same extent as the bank's original liability is reduced. Hence, if a guarantor satisfies the claims against the bank, this party may have an indemnity claim against the bank but only up to the amount that is left after the application of the write-down and conversion powers under the SAG.[186] The legislative history suggests that section 99(8) SAG was introduced, inter alia, for the guarantees (the so-called *Gewährträgerhaftung*) of the public founding entities of the German Sparkassen, Landesbanken or other public sector banks, typically municipal or state governments. The guarantees, although restricted to ensure compatibility with the European Commission's state aid procedures,[187] generally make the banks' owners fully liable for the banks' obligations.[188]

The BA 2009 seems to have the most flexible approach. It provides that the resolution authority exercises its bail-in powers in a resolution procedure by making one or more so-called 'resolution instruments', i.e., legal orders. Where the bank is subject to bail-in, these resolution instruments may 'make special bail-in provision with respect to a specified bank', which is done for

183 Section 99(8) SAG reads: '[d]ie Rechte der Inhaber relevanter Kapitalinstrumente oder der Gläubiger gegen Mitschuldner, Bürgen und sonstige Dritte, die für Verbindlichkeiten des Instituts oder gruppenangehörigen Unternehmens haften, werden durch die Anwendung des Instruments der Beteiligung der Inhaber relevanter Kapitalinstrumente oder des Instruments der Gläubigerbeteiligung nicht berührt. Das Institut oder gruppenangehörige Unternehmen sowie deren Rechtsnachfolger werden jedoch durch die Anwendung der in Satz 1 genannten Instrumente gegenüber dem Mitschuldner, dem Bürgen, dem sonstigen Dritten oder anderen Rückgriffsberechtigten in gleicher Weise befreit wie gegenüber dem Inhaber relevanter Kapitalinstrumente oder dem Gläubiger.'

184 *See* Beschlussempfehlung und Bericht des Finanzausschusses (7. Ausschuss), BRRD-Umsetzungsgesetz, Deutscher Bundestag, Drucksache 18/3088, 5 November 2014, p. 328. *Cf.* MünchKomm-InsO/Huber 2014, section 254, para. 25-32; UhlenbruckKomm-InsO/Lüer/Streit 2015, section 254, para. 12-15.

185 *Cf.* Section 767(1) BGB; UhlenbruckKomm-InsO/Lüer/Streit 2015, section 254, para. 14; MünchKomm-InsO/Huber 2014, section 254, para. 25.

186 *See* Engelbach & Friedrich 2015, p. 667. *Cf.* Sections 774 and 426 BGB; UhlenbruckKomm-InsO/Lüer/Streit 2015, section 254, para. 15; MünchKomm-InsO/Huber 2014, section 254, para. 31. Thole 2016, p. 63 notes that Section 254(2) InsO is in literature argued to have unintended side effects, for instance, because it encourages a guarantor to push the principal debtor to fulfil his obligations in the run-up to the insolvency procedure, and that it remains to be seen whether section 99(8) SAG may also have such effects.

187 *See* the European Commission's press release IP/02/343 of 28 February 2002, available at: http://europa.eu/rapid/press-release_IP-02-343_en.htm?locale=en.

188 Beschlussempfehlung und Bericht des Finanzausschusses (7. Ausschuss), BRRD-Umsetzungsgesetz, Deutscher Bundestag, Drucksache 18/3088, 5 November 2014, p. 327-328.

the purpose of, or in connection with, reducing, deferring or canceling a liability of the bank.[189] The BA 2009 allows the BoE, for instance, to cancel a liability owed by the bank, and modify a liability or the terms of a contract under which the bank has a liability.[190] It can use these powers, for example, to reduce a liability of the bank, or discharge 'persons from further performance of obligations under a contract and dealing with the consequences of persons being so discharged.'[191] According to the Banking Act 2009 special resolution regime code of practice, an example of the latter measure is that the BoE discharges the bank from obligations created by a contract, such as a cancelation of future coupon payments.[192] It is the present author's view that the phrase 'dealing with the consequences of persons being so discharged' can be interpreted broadly. It may allow the resolution authority to explicitly provide that following a discharge of the bank from its obligations to a creditor, a guarantor who guaranteed the performance of the underlying contract under a suretyship guarantee is also discharged from his liability under the guarantee. In practice, such a provision may be relevant if doubts exist as to whether the liability of the guarantor is preserved after a reduction or cancelation of the liability of the bank as principal debtor by statute (under the resolution instrument under the BA 2009).[193] The general rule under English private law is, however, that the surety is discharged if the principal liability is extinguished by operation of law.[194] An example provided in the literature is that the guarantor of a hire-purchase contract is discharged from liability when the creditor exercises his right to repossession, which discharges the hirer under the Consumer Credit Act 1974.[195]

The authority the BoE seems to have to explicitly provide what are the consequences of a reduction of a bank's liability on a guarantee bears an interesting likeness to the possible release of a third-party guarantee under a scheme of arrangement under the CA 2006. English courts have held that they have jurisdiction to sanction a scheme that includes the release of a third-party guarantee which the scheme creditors have in respect of their primary claims against the scheme company, even though the third party is not a party to the scheme. In *Re Lehman Brothers (Europe) International* the Court of Appeal held the release of the third-party guarantee to be 'merely ancillary to the arrangement between the company and its own creditors'.[196]

189 Sections 12A(1), (2), (2A) and (3) and 48B(4)(a) BA 2009.
190 Section 48B(1) BA 2009; section 6.38 Banking Act 2009 special resolution regime code of practice, March 2017.
191 Section 48B(6)(b) BA 2009.
192 Section 6.39 Banking Act 2009 special resolution regime code of practice, March 2017.
193 The author is grateful to Ms. S. Paterson for the discussion on this point.
194 McKendrick 2016, para. 30.41; Andrews & Millett 2005, para. 9.021, for discussions of the discharge of a surety by operation of law.
195 Andrews & Millett 2005, para. 9.021, who refer to the case *Unity Finance Ltd v Woodcock* [1963], 1 W.L.R. 455.
196 *Re Lehman Brothers (Europe) International* (in administration) [2009] EWCA Civ 1161, para. 63.

The release would benefit the creditors because an indemnity claim of the guarantor would otherwise adversely affect the balance sheet of the scheme company and thus what they might recover under the scheme.[197]

5.2 Conversion process

5.2.1 Introduction

Paragraph 3 of this chapter discussed a hypothetical application of the bail-in mechanism vis-à-vis a bank which has a negative asset value. The bail-in rules recognize that a bank can also have a positive net asset value, i.e., the total value of its assets is more than the value of its liabilities, instead of a net asset value which is zero or negative.[198]

In the scenario in which the net asset value is positive, the resolution authority converts claims of creditors into shares. The nominal value of the existing shares may be partly written-down first, but the current shareholders have to retain at least the value that would be left for them in an insolvency procedure.[199] The BRRD uses the term 'dilution' of the existing shareholders in this context.[200] New shares or other instruments of ownership are issued, and the existing shareholders do not fully lose their investments, but their economic and voting rights are proportionally reduced.[201]

By contrast, in the scenario in which the net asset value is zero or negative, the resolution authority is required to first fully write-down the nominal value of the shares and other CET1 items, to then write-down other capital instruments and liabilities, and to finally convert claims into equity.[202] The conversion is carried out by way of either a cancellation of existing shares and issuance of new instruments of ownership to the bailed-in creditors or a transfer of the existing shares to them.[203] In this second scenario, the question arises why only a write-down of a bank's liabilities is not sufficient for a loss absorption and recapitalization. Although losses can indeed be absorbed in that way, the effect of only writing-down liabilities would be

197 *See Re La Seda de Barcelona SA* [2010] EWHC 1364 (Ch), para. 15-20 and *see* for a discussion Kornberg & Paterson 2016, para. 3.340-3.343; Payne 2014a, p. 24.

198 *See* European Banking Authority, Final Guidelines on the treatment of shareholders in bail-in or the write-down and conversion of capital instruments, EBA/GL/2017/04.

199 *See* European Banking Authority, Final Guidelines on the treatment of shareholders in bail-in or the write-down and conversion of capital instruments, EBA/GL/2017/04, p. 5-7.

200 Article 47(1)(b) BRRD.

201 *See* the definition of 'dilution' provided by European Banking Authority, Final Guidelines on the treatment of shareholders in bail-in or the write-down and conversion of capital instruments, EBA/GL/2017/04, p. 3-4.

202 *See* European Banking Authority, Final Guidelines on the treatment of shareholders in bail-in or the write-down and conversion of capital instruments, EBA/GL/2017/04, p. 4-5.

203 Article 47(1)(a) BRRD.

advantageous to the bank's existing shareholders. Their shares in the company's capital are not affected while it is likely that they would not retain any value in an insolvency procedure. Moreover, they may benefit if the value of the company increases in the future while the measures do not adhere to the resolution principle that shareholders bear first losses.[204] Therefore, under the BRRD and SRM Regulation, liabilities cannot be written-down if the net asset value of the bank is zero or negative without first also writing-down the nominal value of the share capital.

The central question in the sections below is whether the conversion of debt to equity under the bank resolution rules follows the formalities and practice for such conversion normally followed in a financial restructuring under national law. The BRRD does not prescribe a particular process but requires national law to fill in the technicalities and details of the execution of the conversion.[205] It only requires that procedural impediments to the conversion existing under articles of association, contract or law are removed, which include, for example, pre-emption rights of existing shareholders. Also, resolution authorities are not subject to requirements to obtain consent or approval from any person, to publish a notice or prospectus or to file or register a document with an authority.[206] This means, for example, that no approval of the general meeting of shareholders is necessary for a cancellation of shares of the bank under resolution, that a prospectus does not have to be circulated if shares are issued in a resolution procedure, and that resolution authorities can modify the terms of a contract to which a bank under resolution is a party without consent of the counterparty.[207] The BRRD also provides that banks can be required to maintain at all times a sufficient amount of authorized share capital so that an issuance of new shares can take place.[208]

5.2.2 Conversion process under German law

The SAG and its legislative history both suggest that the application of the bail-in mechanism under German law follows to a large extent general company and insolvency law.

204 Thole 2016, p. 63; Schelo 2015, p. 135. *Cf.* Articles 34(1)(a), 46-48 and 63(1) BRRD. According to Schelo 2015, p. 135-136 in some cases only a debt write-down may be considered, for instance, if the bank is state-owned and no equity can be given to the creditors. *Cf.* Articles 43(4), 63(3) BRRD.

205 Schelo 2015, p. 136.

206 Articles 54 and 63(2) BRRD.

207 *See* De Nederlandsche Bank, 'Operation of the bail-in tool', December 2017, p. 16; Explanatory Notes to the Draft BRRD Implementation Act (*Kamerstukken II* 2014/15, 34208, no. 3), p. 80. *Cf.* Case 41/15, *Gerard Dowling and Others v Minister for Finance* [2016] ECLI:EU:C:2016:836, in which the CJEU held that the interests of shareholders and creditors cannot be held to prevail in all circumstances over the general interest of the stability of the financial system.

208 Article 54(1) BRRD.

The parliamentary notes on the proposal for the SAG explicitly indicate that technically the effect of bail-in is a reduction of the company's nominal share capital and a subsequent capital increase under sections 183, 228 and 229 AktG.[209] In a debt-to-equity-swap under the AktG, such a capital reduction can take place, for instance, to first compensate for a decline in the value of the assets.[210] The subsequent capital increase is then a capital increase against contributions in kind. Creditors acquire shares in the capital in exchange for the assignment of their claims to the company or the remission of the debt.[211] Obviously, the comparison in the parliamentary notes with such a so-called 'Kapitalschnitt'[212] under the AktG is a simplification. For example, under sections 89, 90 and 99 SAG the scope of the write-down powers of the resolution authority does not only extend to a bank's share capital.

Section 99(4) SAG, which closely resembles section 254a(2) InsO on the effect of an insolvency plan in an insolvency plan procedure,[213] provides that the resolution decision replaces all decisions and approvals which company law requires for the ordered measures. Also, resolutions, announcements, and other measures required in the preparation of the measures under company law as well as declarations of involved parties needed for the implementa-

209 Gesetzentwurf der Bundesregierung, BRRD-Umsetzungsgesetz, Deutscher Bundestag, Drucksache 18/2575, 22 September 2014, p. 177, which notes that: '[t]echnisch bedeutet dies, dass im Fall einer Aktiengesellschaft zunächst das Grundkapital gemäß §§ 228, 229 AktG zum Zweck der Verlustdeckung herabzusetzen ist und gleichzeitig eine Kapitalerhöhung gegen Leistung einer Sacheinlage gemäß § 183 AktG durchgeführt wird.' *See also* Schillig 2016, p. 302.

210 Section 229(1) AktG.

211 Section 183 AktG. *See* Schwarz 2015, p. 63 and 70-71. It has been debated in German literature whether in case of conversion into equity under company law, a creditor's claim should be considered a contribution in kind or a contribution in cash under company law and, accordingly, the nominal value or the actual value of the claim is the relevant value. *See* Häfele 2013, p. 55; Simon & Merkelbach 2012, p. 123; Wirsch 2010, p. 1131-1132; Eidenmüller & Engert 2009, p. 543; Ekkenga 2009, p. 589. *Contra* Cahn et al. 2010.

212 *See* e.g., MünchKomm-AktG/Oechsler 2016, section 229, para. 5.

213 *See* Thole 2016, p. 63. Section 254a(2) InsO reads: '[w]enn die Anteils- oder Mitgliedschaftsrechte der am Schuldner beteiligten Personen in den Plan einbezogen sind (§ 225a), gelten die in den Plan aufgenommenen Beschlüsse der Anteilsinhaber oder sonstigen Willenserklärungen der Beteiligten als in der vorgeschriebenen Form abgegeben. Gesellschaftsrechtlich erforderliche Ladungen, Bekanntmachungen und sonstige Maßnahmen zur Vorbereitung von Beschlüssen der Anteilsinhaber gelten als in der vorgeschriebenen Form bewirkt. Der Insolvenzverwalter ist berechtigt, die erforderlichen Anmeldungen beim jeweiligen Registergericht vorzunehmen.' Section 99(4) SAG provides that '[d]ie Abwicklungsanordnung ersetzt für die in ihr angeordneten Maßnahmen alle nach Gesellschaftsrecht erforderlichen Beschlüsse und Zustimmungen, sofern diese nicht bereits vor Anwendung des Instruments der Beteiligung der Inhaber relevanter Kapitalinstrumente oder des Instruments der Gläubigerbeteiligung gefasst worden sind. Ladungen, Bekanntmachungen und sonstige Maßnahmen zur Vorbereitung von gesellschaftsrechtlichen Beschlüssen gelten als in der vorgeschriebenen Form bewirkt. Die Abwicklungsanordnung ersetzt auch alle rechtsgeschäftlichen Erklärungen der Beteiligten, die zur Umsetzung der gesellschaftsrechtlichen Maßnahmen erforderlich sind.'

tion of the measures under company law are deemed to have been effected in the prescribed form. According to the parliamentary notes, section 99(4) SAG

> 'regelt die Einzelanordnungen, die durch die Abwicklungsanordnung gemäß § 77 zu treffen sind, um die wirksame Umsetzung der Instrumente zu erzielen. Insbesondere kann die Abwicklungsanordnung die Einziehung von Anteilen oder Löschung anderer Instrumente des harten Kernkapitals an einem Institut oder gruppenangehörigen Unternehmen, eine Kapitalherabsetzung oder -erhöhung, die Leistung von Sacheinlagen und den Ausschluss von Bezugsrechten vorsehen. Dabei ersetzt der Verwaltungsakt alle für diese Maßnahmen gemäß Gesellschaftsrecht erforderlichen Beschlüsse der Anteilsinhaber.'[214]

Thole questions if it follows from section 99(4) SAG that for the resolution measures in principle all relevant German company law requirements have to be met, but if the resolution decision explicitly includes specific company law measures, the relevant procedural requirements referred to in the section are deemed to have been met.[215] Section 254a InsO takes a similar approach.[216] It is the present author's view that the above-mentioned parliamentary notes suggest that section 99(4) SAG indeed follows this approach. If the resolution decision explicitly provides for company law measures such as capital reduction and increase and disapplication of pre-emption rights to implement the application of the bail-in mechanism, the decision replaces the relevant procedural company law requirements such as shareholder resolutions.

The SAG disapplies several provisions of general company and insolvency law. For instance, section 99(6) SAG, which is largely a copy of section 254(4) InsO,[217] provides that after the conversion of claims into shares the

214 Gesetzentwurf der Bundesregierung, BRRD-Umsetzungsgesetz, Deutscher Bundestag, Drucksache 18/2575, 22 September 2014, p. 176. Translation by the present author: governs the individual orders to be taken by the resolution order under § 77 to achieve the effective implementation of the instruments. In particular, the resolution order may provide for the cancellation of shares or cancellation of other Common Equity Tier 1 instruments in an institution or group of companies, a capital reduction or -increase, the provision of contributions in kind and the exclusion of pre-emption rights. In doing so, the administrative act replaces all shareholder resolutions necessary for these measures under company law.

215 Thole 2016, p. 63.

216 *See* MünchKomm-InsO 2014, section 254a, para. 1-15.

217 Section 254(4) InsO reads: '[w]erden Forderungen von Gläubigern in Anteils- oder Mitgliedschaftsrechte am Schuldner umgewandelt, kann der Schuldner nach der gerichtlichen Bestätigung keine Ansprüche wegen einer Überbewertung der Forderungen im Plan gegen die bisherigen Gläubiger geltend machen.'. Section 99(6) SAG states that: '[w]erden berücksichtigungsfähige Verbindlichkeiten in Anteile oder andere Instrumente des harten Kernkapitals am Institut oder am gruppenangehörigen Unternehmen umgewandelt, kann das Institut oder gruppenangehörige Unternehmen keine Ansprüche wegen einer fehlerhaften Bewertung der umgewandelten Verbindlichkeiten gegen die bisherigen Gläubiger oder Inhaber relevanter Kapitalinstrumente geltend machen.'

new shareholders are not liable for any shortfall in value (*Differenzhaftung*) because their claims were initially overvalued, which risk would otherwise exist for them under the AktG.[218] The literature has argued that the provision suggests that in bail-in under the SAG the creditors' claims are assigned to the bank as contributions to the capital in kind, as would normally be the case in a debt to equity swap under the AktG.[219] Hence, it results in extinction of the claims because the creditors and debtor become the same person.[220] According to the legislative history, making the new shareholders in such a case liable for a shortfall in the value of their claims is not appropriate because these shareholders have neither agreed with the conversion of their claims nor with the conversion rate.[221] Moreover, the German legislature included in the SAG an exception to the statutory subordination of shareholder loans under section 39 InsO. A claim is not subordinated by operation of law if the creditor has also become a shareholder of the company only because of the application of the bail-in mechanism.[222] Accordingly, a situation in which creditors are 'hit twice' because bail-in also affects the remaining claims of these new shareholders is avoided.[223]

Under sections 89 and 90 SAG the relevant capital instruments and liabilities are to be converted into shares or other CET1 instruments ('*Anteile oder andere Instrumente des harten Kernkapitals*').[224] The SAG does not indicate whether a resolution authority can also first convert the capital instruments and liabilities into tradeable instruments that give rights to acquire shares. By contrast, under the BRRD capital instruments and liabilities are converted into shares or into other instruments of ownership, which include instruments that are convertible into or give a right to acquire shares.[225] It is the present author's view that the SAG leaves room for such an interim conversion as long as the result of the process is conversion into CET1 instruments. This interpretation would entail that, at least in theory, under the SAG an exchange mechanic can be used that is similar to the proposed mechanics under the Wft and the BA 2009, which the sections below will discuss. The German resolution authority has not provided clarification as to whether it intends to use such a procedure in bail-in.

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218 *See* Thole 2016, p. 63; Gesetzentwurf der Bundesregierung, BRRD-Umsetzungsgesetz, Deutscher Bundestag, Drucksache 18/2575, 22 September 2014, p. 177. *Cf.* Sections 27(3) and 183(2) AktG.

219 Thole 2016, p. 63

220 Schelo 2015, p. 136.

221 Gesetzentwurf der Bundesregierung, BRRD-Umsetzungsgesetz, Deutscher Bundestag, Drucksache 18/2575, 22 September 2014, p. 177.

222 Section 99(5) SAG.

223 *See* Gesetzentwurf der Bundesregierung, BRRD-Umsetzungsgesetz, Deutscher Bundestag, Drucksache 18/2575, 22 September 2014, p. 177.

224 *Cf.* Section 2(32) SAG, which defines 'Instrumente des harten Kernkapitals' by referring to the requirements for CET1 instruments in Article 28 CRR. Under the CRR CET1 instruments are mainly ordinary shares.

225 Articles 2(61), 47(1)(b) and 63(f) BRRD.

5.2.3 Conversion process under English and Dutch law

The UK and Dutch resolution authorities have both published papers which describe at a high level how the authorities anticipate the conversion process to look like under UK and Dutch law respectively. The resolution authorities may, however, choose a different application of the bail-in mechanism in practice since the BA 2009 and the Wft do not prescribe these procedures.[226] The proposed procedures deviate quite significantly from the usual process for conversion of debt to equity under national company and insolvency law, under which creditors typically agree to cancel all or a part of the debt in exchange for equity in the company, and may also differ from the procedures used for bail-in in other jurisdictions. They seem to have been based on the recommendation of the Financial Stability Board to ex-ante disclose an anticipated bail-in process that facilitates, where relevant, the continued trading of instruments and liabilities until the bail-in procedure is completed, the distribution of equity to the affected creditors, and the identification of former liability holders. Transparency about the intended bail-in process is expected to enhance market confidence in and predictability of the measures.[227]

According to its paper titled 'The Bank of England's approach to resolution', the BoE expects the process to convert relevant capital instruments and liabilities of a bank under resolution into equity, which includes the required valuations, to take 'several months'.[228] It developed a procedure in which bailed-in creditors are first provided certificates of entitlement, and they are delivered a share in the bank under resolution's capital only at a later date. The paper hardly contains explicit references to provisions of English private law that the BoE has to consider to implement the conversion. It does refer to the hierarchy of claims under insolvency law that is followed in bail-in.[229] The BA 2009 provides that the provisions on bail-in in a resolution instrument take effect 'despite any restrictions arising by virtue of contract or legislation or in any other way'.[230]

226 The parliamentary notes to part 3a Wft briefly discuss a procedure for the execution of bail-in under Dutch law that is similar to the procedure proposed by the Dutch resolution authority. *See* Explanatory Notes to the Draft BRRD Implementation Act (*Kamerstukken II* 2014/15, 34208, no. 3), p. 22-23 and 92.

227 Financial Stability Board, 'Principles on bail-in execution', 21 June 2018, principle 10.

228 Bank of England, 'The Bank of England's approach to resolution', October 2017, p. 37. *See also* Philippon & Salord 2017, p. 47: '[r]egulators have about 50 hours to resolve a bank (from Friday night in New York to Monday morning in Tokyo). On the other hand, it takes at least six months to value the assets (six months is the estimate of the Bank of England and is probably a lower bound).'

229 Bank of England, 'The Bank of England's approach to resolution', October 2017, p. 18.

230 Section 48S(1) BA 2009.

When a bank enters a resolution procedure, the BoE first announces which capital instruments and liabilities may fall within the scope of bail-in and suspends trading, or cancels the listing of, instruments. Legal title to the existing shares of the bank under resolution is transferred to a third-party depositary bank, which holds the shares on trust on behalf of the bailed-in creditors until they can be delivered to these creditors.[231] An administrator controls the voting rights of the shares during this period. In the meantime, the creditors are provided various types of tradeable instruments, i.e., certificates of entitlement, by the bank under resolution, which different types reflect the different creditors' positions in the creditor hierarchy. The certificates are issued into the accounts of the central securities depository of the creditors and represent a right to potentially receive shares as compensation.[232] Accordingly, bailed-in creditors who do not want or are not allowed to become a shareholder of a bank can sell the entitlements.[233] The different types of certificates will form the basis for the use of different conversion rates for different classes of creditors, such as a different rate for junior creditors than for senior creditors. Once the required valuations are finalized and the resolution authority announces the final terms of bail-in, the holders of the certificates will have to prove their beneficial ownership of the shares in the bank and give instructions for the delivery of the shares. If they do so, the depository bank credits the shares to their central securities depositary accounts, and the certificates are cancelled.[234] Accordingly, the overall result of the process is conversion of claims of creditors against the bank in shares in the capital.[235]

The Dutch legislature and the Dutch resolution authority have proposed a similar procedure with claim rights, i.e., claim rights to newly issued shares in the capital of the bank, to implement the conversion under Dutch law.[236]

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231 *See* Gracie 2014, p. 416.

232 *See* Bank of England, 'The Bank of England's approach to resolution', October 2017, p. 38; Gracie 2014, p. 416.

233 *Cf.* Coffee 2010, p. 35: 'if the debt security converts into common stock, the newly issued common stock would predictably come to be owned by the same categories of institutional investors as already held that common stock. Little would change. This is both because some debt investors (for example, money market funds) cannot legally hold common stock and, more generally, because the holders of debt securities tend to be risk averse (or at least want to maintain their prior portfolio balance and so, after conversion, will replace the former debt security that they held with a new debt security by selling the common stock that they receive).'

234 *See* Bank of England, 'The Bank of England's approach to resolution', October 2017, p. 37-38; Gracie 2014, p. 416.

235 *Cf.* Section 583(3)(c) CA 2006, under which the release of a liability of the company for a liquidated sum is in a debt to equity swap under company law normally considered a contribution in cash to the capital of the company.

236 De Nederlandsche Bank, 'Operation of the bail-in tool', December 2017, p. 9; Explanatory Notes to the Draft BRRD Implementation Act (*Kamerstukken II* 2014/15, 34208, no. 3), p. 22-23 and 92.

It has been argued in the legislative history of part 3a Wft, however, that for the sake of clarity a procedure in which the conversion of claims into shares is directly implemented is to be preferred instead of this procedure with claim rights.[237]

Section 3a:6 Wft provides that DNB's decision on the application of the bail-in mechanism, including the preparation or implementation, is not subject to specific requirements. More particularly, under subsection 1 it is not subject to any consent requirements, which include requirements for approval of the general meeting of shareholders in sections 2:96 and 2:99 BW. Under subsection 2, the decision is not subject to any notification or procedural requirement, including the procedural requirement under section 2:100 BW to give creditors the opportunity to lodge an objection against a measure and the procedural requirement for an audit opinion under sections 2:94a and 2:94b BW. An exception is that the bank under resolution and several authorities have to be notified under articles 81 and 83 BRRD. Under subsection 3, the decision is not subject to any other limitation imposed by law, articles of association or contract. The minimum capital requirement for a public limited liability company under section 2:67 BW is an example of the latter limitation.[238]

Sections 3a:21(1) and 3a:44(1) Wft provide an explicit legal basis for the conversion process with the above-mentioned claim rights. The provisions empower DNB to convert capital instruments and liabilities into rights to newly issued shares. Hence, the conversion into the claim rights takes place by operation of law pursuant to the administrative decision of DNB. Under sections 3a:22(1) and 3a:45(1) Wft DNB may require the bank under resolution to issue new shares. According to a paper published by DNB, if not all creditors entitled to the claim rights are yet known, the creditors will be asked to contact the bank themselves. Also, the claim rights are transferable but are not necessarily listed on an official market.[239] The resolution authority expects to set a fixed period of a few weeks in which the claim rights are to be exercised, following either the issuance of the rights or the announcement of the conversion rates. Unexercised claim rights then expire, and unclaimed shares are sold in the market.[240]

The question arises what is the precise nature of the claim rights in the resolution procedure under the Wft. Van der Velden and De Serière classify

237 Annex to *Kamerstukken II* 2014/15, 34208, no. 5, p. 7 (Comments to the proposal for the Implementation Act European framework for recovery and resolution of banks and investment firms of G.W. Kastelein & V.P.G. de Serière, 23 June 2015).

238 *See* Explanatory Notes to the Dutch Draft Amending Act Financial Markets 2017 (*Kamerstukken II* 2016/17, 34634, no. 3), p. 13-15; Explanatory Notes to the Dutch Draft BRRD Implementation Act (*Kamerstukken II* 2014/15, 34208, no. 3), p. 80-82.

239 De Nederlandsche Bank, 'Operation of the bail-in tool', December 2017, p. 9 and 21.

240 De Nederlandsche Bank, 'Operation of the bail-in tool', December 2017, p. 11.

them as personal claims (*vorderingen op naam*).[241] According to DNB, the claim rights bear a resemblance to pre-emption rights of shareholders under section 2:96a BW.[242] Indeed, the claim rights seem to be comparable with pre-emption rights because they are also transferable and can be exercised against the bank in relation to an issue of new shares. They are optional rights (*wilsrechten*), which means that with a declaration of intent (*wilsverklaring*) a new legal relationship (*rechtsbetrekking*) is created, [243] i.e., the right holders become shareholders.

An important difference between the proposed UK and Dutch conversion procedures is, for example, that in the procedure of the BoE the existing shares in the capital of the bank are transferred to a depository bank and finally to the certificate holders.[244] In the Dutch procedure, by contrast, new shares are issued to be first held on trust (*ten titel van beheer*) by a newly created foundation and finally transferred to the claim right holders. The existing shares in the capital of the bank are canceled rather than transferred by the resolution decision.[245]

It is the present author's view that the papers do not address all relevant aspects of the conversion procedures. To take an example, in contrast to the BoE paper, the Dutch paper does not discuss if different types of claim rights are issued for the different types of creditors, as a basis for different conversion rates for different classes of creditors in the creditor hierarchy.

Furthermore, it remains unclear in both papers whether the tradeable certificates/claim rights are to be transferred together with the part of a liability to the creditor that is not reduced by the resolution authority and with the rights to a potential write-up at a later stage. If a certificate/right holder can sell his certificate/claim right separately from the non-reduced part of his claim against the bank, it may become unclear who is entitled to a write-up of the bailed-in claim of the creditor at a later stage.[246]

Moreover, the Dutch paper and the Wft do not provide how the application of the bail-in mechanism relates to section 3:229 BW. Under this section, a right of pledge (*recht van pand*) or right of mortgage (*recht van hypotheek*)

241 Van der Velden & De Serière 2018, p. 58.
242 De Nederlandsche Bank, 'Operation of the bail-in tool', December 2017, p. 9.
243 Snijders & Rank-Berenschot 2017, para. 30. *See also* Snijders 1999.
244 Bank of England, 'The Bank of England's approach to resolution', October 2017, p. 38.
245 De Nederlandsche Bank, 'Operation of the bail-in tool', December 2017, p. 10.
246 DNB discusses this question in both its consultation and its final paper but does not answer the question. It only mentions that it realizes 'that linking claim rights to converted claims is complex and [that it] will study this in more detail.' De Nederlandsche Bank, 'Operation of the bail-in tool', December 2017, p. 22; De Nederlandsche Bank, 'Operation of the bail-in tool', consultation paper June 2016, p. 16.

entails by operation of law a right of pledge on all claims for compensation which take the place of the secured assets. This provision on proprietary substitution (*substitutiepandrecht*) applies, for example, to actions arising from an unlawful act (*onrechtmatige daad*), insurance claims and compensation for expropriation. If a mortgaged house is burnt down, the former mortgage holder is granted a right of pledge on the fire insurance claims against the insurance company.[247] It is the present author's view that it would be consistent with current practice if the rule on propriety substitution applies if pledged claims against or pledged shares in the capital of the bank under resolution are bailed-in. The right of pledge would be substituted with a right of pledge on shares after conversion of a creditor's claim or on a compensation claim, such as claims the bank's former creditors and shareholders potentially have in accordance with the no creditor worse off-principle.[248]

Also, both the DNB paper and the BoE paper do not discuss if the market value of the claim rights/certificates of entitlement plays a role in the determination of the rate of conversion of debt to equity. The papers do consider that the rights/certificates may be traded before the exercise of the rights. The resolution authority uses this period to set the conversion rates and, hence, to decide how much equity value each holder of claim rights/certificate holder receives. It follows from articles 36 BRRD and 20 SRM Regulation and a Commission Delegated Regulation that the allocation of value to a creditor in bail-in depends on the economic valuation of the bank's assets and liabilities and on the estimated market value of the shares that are issued or transferred to the right holder/certificate holder as consideration.[249] The BRRD requires the resolution authorities to set a conversion rate that ensures that creditors and shareholders receive at least the value which they would have received had the bank been wound up under national insolvency law (the no creditor worse off-principle). It means that the expected value of the combined equity and debt claims of these stakeholders after bail-in has to be equal or greater than their expected realization in an insolvency procedure.[250] Moreover, the BRRD requires the

247 Snijders & Rank-Berenschot 2017, para. 509; Asser/Van Mierlo & Van Velten 3-VI* 2010/58-60.

248 *Cf.* 3a:20 Wft.

249 *See* Articles 1(h) and 10-13 Commission Delegated Regulation (EU) 2018/345 of 14 November 2017 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for assessing the value of assets and liabilities of institutions or entities (OJ L 67, 9.3.2018, p. 8–17). *See also* Bank of England, 'The Bank of England's approach to resolution', October 2017, p. 36-37.

250 *See* Articles 50 and 75 BRRD; European Banking Authority, 'Final Guidelines on the rate of conversion of debt to equity in bail-in', EBA/GL/2017/03, 5 April 2017, para. 1.16-1.23. *See also* section 6C(4)(d) BA 2009; sections 3a:21(3) and 3a:44(3) Wft; section 98 SAG.

resolution authorities to respect the insolvency creditor hierarchy.[251] Thus, in principle, each euro of claims of subordinated creditors should not be allocated more value of equity claims than each euro of claims the senior creditors is receives.[252]

In practice, the value of a failing company's business and shares is often uncertain. In corporate financial restructurings procedures under Dutch and English law, including the proposed extrajudicial restructuring plan (*onderhands akkoord*) procedure under the Fw and the scheme of arrangement procedure under the CA 2006, a court has to assess the value to confirm the restructuring plan. The English literature,[253] and to a lesser extent also the Dutch literature,[254] have debated which valuation methods should be used in these procedures to determine, amongst other things, which creditors and shareholders should receive any value under the restructuring plan. In scheme of arrangement procedures, the English courts traditionally put weight on the hypothetical positions of the creditors and shareholders if the schemes were not sanctioned to determine, for instance, who should be allocated an equity stake.[255]

Sections 6E and 48X BA 2009, article 20 SRM Regulation and a related Commission Delegated Regulation do not seem to prevent a valuer in a bank resolution procedure from taking into account the market value of the claim rights/certificates to estimate the market value of the shares that are to be allocated to the former creditors.[256] However, a valuer may decide not to base its decisions on the market value of the claim rights/certificates if this value does not fully represent the accurate share value. It is the present author's view that the value of the claim rights/certificates may be used for other purposes in the context of a resolution procedure. Assume, for example, that former creditors of the bank use the information about the value of the claim rights/certificates in a valuation dispute following the procedure to argue that the estimated market value of the shares allocated to them

251 *See* Articles 34(1)(a), (b) and (f) and 50 BRRD; European Banking Authority, 'Final Guidelines on the rate of conversion of debt to equity in bail-in', EBA/GL/2017/03, 5 April 2017, para. 1.24-1.26.

252 Huertas 2012, p. 81.

253 *See* Paterson 2017, p. 612-613; Kornberg & Paterson 2016, para. 3.383-3.397; Payne 2014a, p. 249-253.

254 *See* e.g., Van den Berg 2017, who discusses the valuation approach adopted in the prposed extrajudicial restructuring plan (*onderhands akkoord*) procedure under the Fw. *See also* Tollenaar 2016, p. 123-139 for a discussion of valuation in corporate restructuring plan procedures in general.

255 *See* Paterson 2017, p. 612-613; Kornberg & Paterson 2016, para. 3.383-3.397.

256 *Cf.* Article 36 BRRD; Articles 1(h) and 10-13 Commission Delegated Regulation (EU) 2018/345 of 14 November 2017 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for assessing the value of assets and liabilities of institutions or entities (OJ L 67, 9.3.2018, p. 8–17).

was incorrect.[257] These former creditors are likely to be highly motivated to advocate a lower market value of their shares so that they can claim, for instance, a greater stake in the capital of the resolved bank. This is particularly relevant if the price of the claim rights/certificates was depressed because they were traded in a period in which the bank is in financial distress and the outcomes of the resolution procedure were uncertain. The market value of the claim rights/certificates is then a piece of information available in the jurisdictions in which the conversion procedures with the claim rights/certificates are used. It could result in, for example, valuation disputes based on different pieces of information following resolution procedures under English and Dutch law than under the laws of Member States which do not follow a similar conversion procedure.[258]

5.3 Hierarchy of claims in bail-in

5.3.1 Introduction

A fundamental question in the design of a bank resolution framework is to whom and in what order the losses and costs of the recapitalization of a bank under resolution are allocated.[259] This paragraph discusses the role of national insolvency law in the determination of the priority amongst shareholders and creditors in bail-in. The central question is how the hierarchy of claims in bail-in, including the protection offered by the bail-in rules to several types of claims by excluding them from bail-in, relates to the insolvency ranking of claims recognized under national law.

5.3.2 Hierarchy of claims in bail-in

One option for the loss allocation in bail-in is to apply the rules of the applicable insolvency law on the distribution of proceeds in liquidation. Traditionally, the starting point in such a distribution is the *pari passu* treatment of creditors, which means that all creditors are paid *pro rata* to the extent of their pre-insolvency entitlements.[260] This principle has been considered

257 *Cf.* Article 36(13) BRRD; article 20(15) SRM Regulation.

258 The author is grateful to Ms. S. Paterson for the discussion on this point.

259 *See* Hüpkes 2011, para. 5.11-5.32.

260 Finch & Milman 2017, p. 511. *Cf.* Section 3:277(1) of the Dutch Civil Code (*Burgerlijk Wetboek*), which provides that, in principle, creditors have amongst each other and in proportion to the amount of their claims an equal right to be paid from the net proceeds of the debtor's assets. According to Section 14.12(2) Insolvency (England and Wales) Rules 2016, in administration and winding-up by the court '[d]ebts other than preferential debts rank equally between themselves and, after the preferential debts, must be paid in full unless the assets are insufficient for meeting them, in which case they abate in equal proportions between themselves.'

the most fundamental principle of insolvency law.[261] However, insolvency laws generally do not rigidly apply the principle but contain priority rules and recognize a ranking or hierarchy of claims or creditors in liquidation to determine who are paid first out of the available pool of assets. According to the literature, such a ranking reflects legal, social and moral decisions made and policy goals pursued in a specific jurisdiction and has often been developed over a long period.[262] For example, under many national insolvency laws employees of an insolvent company enjoy priority over the general body of creditors in liquidation for the claims for unpaid wages.[263] The ranking is also of relevance in other types of insolvency procedures, such as for the formation of classes of creditors in a reorganization procedure.[264]

Another approach is to protect certain types of liabilities by excluding them from the scope of bail-in.[265] One of the primary objectives of insolvency law is traditionally the satisfaction of the creditors to the maximum extent possible. Hence, insolvency procedures are directed towards the protection of the private interests of parties. As will be further discussed in chapter 6, bank resolution procedures under the BRRD and SRM Regulation, by contrast, are thought to pursue mainly the resolution objectives that include the objectives to protect critical functions of the bank and avoid adverse effects on the financial system.[266] Thus, the procedures are oriented towards the protection of public interests. These objectives justify the exclusion of several categories of liabilities in bail-in to avoid that risks spread to other parts of the financial system and to enable the bank to continue its day-to-day operations. Bank liabilities subject to contagion risks, such as deposits, as well as liabilities arising from essential services and business lines are to be exempted from bail-in.[267] Although this means that the excluded liabilities

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261 Bork 2017, p. 115-117; Goode 2011, para. 8.02. *See also* Wiórek 2005, p. 74. The EU Recast Insolvency Regulation and the Winding up Directive recognize the importance of the principle. Article 23(2) Recast Insolvency Regulation: '[i]n order to ensure the equal treatment of creditors, a creditor which has, in the course of insolvency proceedings, obtained a dividend on its claim shall share in distributions made in other proceedings only where creditors of the same ranking or category have, in those other proceedings, obtained an equivalent dividend.' Recital 12 Winding up Directive: '[t]he principle of equal treatment between creditors, as regards the opportunities open to them to take action, requires the administrative or judicial authorities of the home Member State to adopt such measures as are necessary for the creditors in the host Member State to be able to exercise their rights to take action within the time limit laid down.'

262 De Serière 2014, p. 166-167; Mucciarelli 2013, p. 179-180; Garrido 1995, p. 25-53. For an overview of the statutory insolvency ranking in various jurisdictions, *see* Wessels & Madaus 2017, p. 240-250; McCormack et al. 2016, p. 112-136; Faber et al. 2016.

263 UNCITRAL, 'Legislative Guide on Insolvency Law', Part 2 2004, p. 272-273.

264 Wood 2013, p. 212-213.

265 *See* Huertas 2013, p. 172-173.

266 Article 31(2) BRRD; Article 14(2) SRM Regulation.

267 *See* De Serière 2014, p. 166-170; Bliesener 2013, p. 198-209. *See also* Gleeson & Guynn 2016, para. 1.07.

preserve their original position in insolvency, in bail-in they are treated *de facto* senior to debt that is 'bail-inable'.[268]

The bail-in rules in the BRRD and SRM Regulation combine the insolvency ranking of claims under national law with the approach mentioned above to carve out various types of claims in the public interest.[269]

The so-called 'resolution principles' provide a further starting point for the hierarchy of claims in bail-in.[270] According to the principles, the bank under resolution's shareholders bear first losses and its creditors take losses after the shareholders, in principle in accordance with the ranking of claims recognized under national insolvency law. Moreover, creditors in the same class are treated equitably, unless otherwise stipulated in the BRRD and SRM Regulation. The latter principle is reflected in the provision that in bail-in the losses are to be allocated pro-rata between capital instruments and liabilities of the same rank.[271] In the Netherlands and Germany, article 15(1) SRM Regulation explicitly provides for the resolution principles. The Dutch ministerial Regulation on the performance of duties and cross-border cooperation by financial supervisors Wft (*Regeling taakuitoefening en grensoverschrijdende samenwerking financiële toezichthouders Wft*) and section 68 SAG also refer to them. Furthermore, the resolution principles are reflected in several sections of the BA 2009[272] and can more explicitly be found in sections 6.7-6.12 of the Banking Act 2009 special resolution regime code of practice.

In addition to the resolution principles, the BRRD and SRM Regulation provide for a list with liabilities excluded from bail-in. The excluded liabilities are (i) the part of deposits covered by a deposit guarantee scheme,[273] (ii) secured liabilities,[274] (iii) liabilities arising from the holding of client assets or client money or from the bank acting as a fiduciary in a fiduciary relationship, (iv) short-term liabilities to other institutions and to payment

268 Chan-Lau & Oura 2016, p. 21.

269 Articles 44 and 48(1) BRRD; Articles 17 and 27(3) and (5) SRM Regulation. *See also* Recital 77 BRRD, which provides that '[e]xcept where otherwise specified in this Directive, resolution authorities should apply the bail-in tool in a way that respects the pari passu treatment of creditors and the statutory ranking of claims under the applicable insolvency law.'

270 Article 34(1) BRRD; Article 15(1) SRM Regulation.

271 Article 48(2) BRRD; Article 17(1) SRM Regulation.

272 E.g., Sections 6B, 12AA, 20, 36A, 48B(8) and 48N BA 2009.

273 Article 6 Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (OJ L 173, 12.6.2014, p. 149–178).

274 Article 2(1)(67) BRRD defines 'secured liability' as 'a liability where the right of the creditor to payment or other form of performance is secured by a charge, pledge or lien, or collateral arrangements including liabilities arising from repurchase transactions and other title transfer collateral arrangements.' Under Article 44(2) BRRD the part of a secured liability or a liability for which collateral has been pledged that exceeds the value of the assets, pledge, lien or collateral against which it is secured, falls within the scope of bail-in.

and securities settlement systems, (v) certain liabilities owed to employees, (vi) liabilities owed to commercial and trade creditors arising from the provision of goods and services that are 'critical to the daily functioning' of the bank's operations, such as IT services,[275] (vii) liabilities owed to tax and social security authorities, provided that they qualify as preferential liabilities under national law, and (viii) liabilities owed to deposit guarantee schemes.[276] The resolution authorities also have discretion to exclude or partially exclude other categories of liabilities in exceptional circumstances. Such an exclusion is, for instance, allowed if the authorities find that 'it is strictly necessary and proportionate to achieve the continuity of critical functions and core business lines' or 'to avoid giving rise to widespread contagion'.[277] The literature notes that a resolution authority may on this basis exclude, for example, derivatives liabilities that are not secured liabilities or short-term liabilities to other institutions.[278]

Also, the BRRD and SRM Regulation create a ranking between a bank's subordinated liabilities. They require that losses are imposed on capital instruments that count as AT 1 and T2 capital instruments under the CRR, which are subordinated liabilities to investors in the bank, before other subordinated liabilities. Only if AT1 and T2 instruments are reduced in full, other subordinated debt and senior debt are to be reduced or converted in ascending order under national insolvency law.[279] Furthermore, as discussed in paragraph 5.3.4 below, the BRRD now creates a new debt class that can be bailed-in immediately after contractually and statutory subordinated liabilities have been bailed-in.[280]

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275 De Nederlandsche Bank, 'Operation of the bail-in tool', December 2017, p. 3 seems to incorrectly state that excluded liabilities include 'claims of commercial or trade creditors <u>and</u> claims arising from the provision of goods or services to the Bank that are critical to the daily functioning of its operations' (emphasis added, LJ). Article 44(2) BRRD and article 27(3) SRM Regulation, by contrast, provide that the excluded liabilities include liabilities to 'a commercial or trade creditor <u>arising</u> from the provision [...] of goods or services that are critical to the daily functioning of its operations' (emphasis added, LJ).

276 Article 44(2) BRRD; Article 27(3) SRM Regulation.

277 Article 44(3) BRRD; Article 27(5) SRM Regulation. On the discretionary exclusion of liabilities from bail-in *see* Gardella 2015, p. 394-396. Franke, Krahnen & Von Lüpke 2014, p. 564 and Adolff & Eschwey 2013, p. 964 argue against such a power for resolution authorities to exclude liabilities. According to Tröger 2018, p. 57-60, the terms used to exclude liabilities from the scope of bail-in are vague, and the margin of discretion given to authorities is a source of legal uncertainty.

278 Bliesener 2013, p. 205-208. *Cf.* Article 49 BRRD; Recital 17 Commission Delegated Regulation (EU) 2016/860 of 4 February 2016 specifying further the circumstances where exclusion from the application of write-down or conversion powers is necessary under Article 44(3) of Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (OJ L 144, 1.6.2016, p. 11–20); Section 4 Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 (SI 2014/3350).

279 Article 48(1) BRRD; Article 17(1) SRM Regulation.

280 Article 108(2)-(7) BRRD.

5.3.3 National insolvency rankings of claims

The sections below offer a brief overview of the insolvency ranking of claims under Dutch, German, and English law. They show that the three jurisdictions have own approaches to this hierarchy. They all provide directly or indirectly for the protection of several categories of creditors.

Most of the Dutch provisions that grant priorities to particular types of creditors and claims can be found in the BW and specific statutes rather than the Fw.[281] Section 3:278 BW provides that creditors who can assert a right of pledge, right of mortgage, preferential right (*voorrecht*),[282] or another statutory ground for priority, such as the possessory lien[283] (*retentierecht*), are granted priority. Accordingly, in case of a 'concursus creditorum' a right of mortgage and right of pledge can be exercised as if the insolvency procedure had not been opened and tax authorities and employees have, amongst others, a right to preferential payment.[284] Claims against the insolvency estate (*boedelvorderingen*), i.e., essentially the costs of the insolvency procedure,[285] are to be paid in priority to all insolvency claims.[286] Several other rights, such as set-off rights, give creditors quasi-priority (*feitelijke preferentie*).[287] The literature notes that most of the priorities granted under Dutch law can be historically explained. The reasons that have been put forward in legislative history for the priority status of tax claims, for example, include that the public treasury cannot choose its debtors.[288] The result is a complex system with many classes of creditors that need to be paid in priority to the ordinary unsecured, non-preferential insolvency creditors, and the latter group of creditors often receives nothing in a bankruptcy procedure.[289] Several authors believe that the principle that creditors have equal rights to proportional payment does not amount that much under Dutch insolvency law.[290]

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281 *Cf.* Wiórek 2005, p. 140-141, who discusses in which European countries the ranking of claims can be found in general private law provisions, in which the order can be found in a special insolvency act, and in which the order can be found in general insolvency law. For a discussion of all types of insolvency and administration claims under Dutch law, *see* Faber & Vermunt 2016.

282 Sections 3:283-289 BW distinguish between specific privileges and general privileges.

283 Sections 3:290-291 BW.

284 Section 57(1) Fw; Sections 3:278, 3:288(c)-(e) BW; Section 21 Tax Collection Act 1990 (*Invorderingswet*). For a discussion of the priorities based on security rights, preferential rights, and other statutory grounds, *see* Verstijlen 2006, p. 1157-1228; Erasmus 1976.

285 Van Buchem-Spapens & Pouw 2013, p. 62. The Fw does not define the term 'boedelschulden', the exact meaning derives from case law.

286 For a discussion of the administration claims (*boedelvorderingen*), *see* e.g., Van Mierlo 2004; Verstijlen 1998, p. 165-189.

287 Section 53 Fw. *See* Verstijlen 2006, p. 1219-1220.

288 Erasmus 1976, p. 37, 56-79.

289 *See* Wessels 2010; Verstijlen 2006, p. 1161.

290 E.g., Hummelen 2016, p. 16-17; Wessels 2010; Van Apeldoorn 2010, p. 25-42; Vriesendorp 2001, p. 3-11.

Proposals to change the current system for the distribution of the realization proceeds by, for instance, limiting the scope of the administration claims (*boedelvorderingen)* and preferential claims,[291] have been very much debated in the literature but no significant changes have been adopted so far.[292]

The approach of Dutch insolvency law to preferential rights in insolvency shows some similarity to the policy of English insolvency law. Both laws recognize several types of creditors whose insolvency claims are satisfied ahead of the insolvency claims of the ordinary unsecured, non-preferential creditors. In winding-up and in administration under English law, creditors with fixed security, including a mortgage or a lien, or quasi-security, such as a retention of title, can realize the security to satisfy their claims.[293] Provided that the ranking has not been altered by agreement, the next in line are successively (1) creditors with claims resulting from expenses in the procedure, such as the remuneration of the office holder and post-liquidation transactions,[294] (2) preferential creditors, (3) floating charge holders, and then (4) creditors with unsecured insolvency claims. Only if the claims of these creditors are satisfied, statutory interest, non-provable liabilities,[295] and the shareholders are successively paid. The English legislature changed the order of priorities following the in 1982 published report of the Cork Committee, which investigated and provided recommendations on the reform of English insolvency law. The report notes that, at that time, a *pari passu* distribution of unencumbered assets was seldom, if ever, achieved in practice because of the existence of many types of debts that had to be paid in priority to the unsecured insolvency claims.[296] The changes that were introduced by the Enterprise Act 2002 include the abolishment of the preferential treatment of tax claims. Moreover, the legislature introduced the rule that a prescribed part of the insolvency company's assets that would otherwise be used to satisfy the claims of floating charge holders, has to be used to pay the creditors with unsecured insolvency claims.[297] The category of preferential liabilities now still includes liabilities to employees.[298]

291 *See* Mennens 2013; Van Mierlo 2004.
292 Faber & Vermunt, para. 12.03.
293 Bank of England, 'The Bank of England's approach to resolution', October 2017, p. 18; Schillig 2016, p. 367.
294 Section 115 IA 1986; Rules 3.50 and 7.108 Insolvency Rules 2016. *See* Goode 2011, para. 8.32-39.
295 Non-provable liabilities are liabilities that are incurred during the insolvency procedure but do not qualify as expenses of the procedure, such as tort liabilities where the cause of action arises after the start of the procedure. *See* Anderson, Cooke & Gullifer 2016, para. 8.21-22.
296 Cork Report 1982, p. 317. *See also* Finch & Milman 2017, p. 515.
297 Goode 2011, para. 8.20. *Cf.* Section 176A IA 1986.
298 Section 386 IA 1986; Schedule 6 to the IA 1986, para. 8-10 and 13. *See also* Anderson, Cooke & Gullifer 2016, para. 8.62.

In Germany, most of the provisions on the different categories of creditors in insolvency procedures can be found in the InsO. Until 1999, specific groups of creditors, such as employees, churches, social security authorities, and schools, were granted the privilege in insolvency of being paid before the general class of insolvency creditors. It was generally acknowledged at that time that for specific reasons these groups were not all free to choose on their debtor.[299] With the enactment of the InsO, the separate classes with creditors who were granted preferential treatment were formally abolished.[300] The legislative history indicates that the privileges based on the personal characteristics of creditors were considered arbitrary. One of the purposes of the reforms was to create a fairer distribution in insolvency procedures ('[m]*ehr Verteilungsgerechtigkeit im Insolvenzverfahren*') as in many procedures at that time a large part of the proceeds of the realization of the debtor's assets were used to pay the preferential claims.[301] Nevertheless, this does not mean that the InsO does not acknowledge different creditor groups. Four groups of creditors are distinguished: (1) creditors who are entitled to claim separation of specific assets from the estate (*Aussonderungsberechtigte Gläubiger)*,[302] such as creditors with a right of ownership or usufruct, and creditors who have the right to claim privileged distribution of proceeds (*Absonderungsberechtigte Gläubiger)*,[303] including creditors with a security right; (2) creditors with administration claims (*Masseverbindlichkeiten*),[304] such as the insolvency court for court fees incurred after the commencement of the insolvency procedure, (3) general insolvency creditors, and (4) subordinated creditors.[305] Moreover, according to several scholars, in essence, German insolvency law still acknowledges preferential rights for

299 Ruzik 2010, p. 658; KuhnKomm-KO/Uhlenbruck 1994, Section 61, para. 24.

300 Ruzik 2010, p. 667; Wiórek 2005, p. 102-103. On the historical developments in the field of German insolvency law and the introduction of the InsO *see* Kodek 2014, p. 221-222; MünchKomm-InsO/Stürner 2013, Einleitung, para. 31-45c.

301 Gesetzentwurf der Bundesregierung, Entwurf einer Insolvenzordnung (InsO), Deutscher Bundestag, Drucksache 12/2443, 15 April 1992, p. 81 and 90. *See* Ruzik 2010, p. 671; Wiórek 2005, p. 107; According to UhlenbruckKomm-InsO/Pape 2015, section 1 InsO, para. 12 the privileges were considered 'der Feind jeden Rechts.' For a discussion of the changes to German insolvency law as of 1999, *see* Kamlah 1996, p. 417-435, who notes at p. 434 that under the former insolvency legislation 'virtually all of the debtor's encumbered assets are generally needed to pay the many priority claims, if a proceeding goes forward at all. Under new laws, these former priority claims will be dealt with on an equal basis with all other unsecured claims, thus presumably increasing the average dividend payable to general unsecured creditors.'

302 Section 47 InsO.

303 Sections 49-52 InsO.

304 Sections 53-55 InsO.

305 Under Section 39 InsO some claims are subordinated by operation of law, but parties may also contractually agree on the subordination.

certain creditors.[306] Given that some claims of tax authorities are treated as administration claims, and set-off and netting rights grant creditors *de facto* privileges in insolvency, the literature argues that the InsO uses mechanisms that have a similar effect as awarding formal preferential treatment over the general insolvency creditors.[307] Also, liabilities under a social plan (*sozial plan*) that may be adopted to protect the employees in an insolvency procedure are granted a *de facto* privilege as they qualify as administration claims.[308]

In sum, Dutch and English law provide for a complex statutory ranking in insolvency. German insolvency law recognizes four creditor groups and indirectly protects some other types of creditors, although it does not provide for a class with creditors who are formally granted preferential rights. The national insolvency laws, primarily Dutch and English law, protect some categories of creditors for social reasons, such as employees, some to ensure orderly conduct of the insolvency procedure, such as the insolvency office holder regarding his remuneration, and some because they perform essential public functions, such as tax authorities. Secured creditors enjoy priority treatment to the extent the value of the collateral covers their claim because they have ex-ante bargained for such a treatment.[309]

The bail-in rules create a different system to protect creditors. On the one hand, they recognize the policy of Dutch, German, and English insolvency law by following in bail-in the national insolvency ranking of claims. On the other hand, they derogate from the insolvency law system by also excluding classes of liabilities from the scope of the bail-in mechanism.[310] In particular, the bail-in rules exclude several types of debts that are granted a priority treatment under the national insolvency laws. Examples are debts to secured creditors, which have a priority treatment under Dutch, German, and English insolvency law, financial obligations to employees, which are preferential insolvency claims under Dutch and English law, and liabilities to tax authorities, which have a preferential treatment under Dutch insolvency law. The resolution rules also exclude short-term liabilities with an original maturity of less than seven days to other institutions from the scope of bail-in but these liabilities rank *pari passu* with other senior unsecured

306 Kodek 2014, p. 222; Bauer 2007, p. 188-192; Stürner 2005, p. 597-598. For a discussion of the *par condition creditorum*-principle in German insolvency law, see MünchKomm-InsO/Breuer 2014, section 226, para. 1-6; MünchKomm-InsO/Stürner 2013, Einleitung, para. 1; MünchKomm-InsO/Ganter/Lohmann 2013, section 1, para. 51-52; Ruzik 2010, p. 647 and 666-667.

307 Paulus & Berberich 2016, para. 10.06, 10.51-52

308 Section 53 and 123 InsO; Bauer 2007, p. 190-191.

309 *Cf.* Wessels & Madaus 2017, p. 240; UNCITRAL, Legislative Guide on Insolvency Law Part 2 2004, para. 53.

310 *See* Bliesener 2013, p. 198-209.

liabilities under the national laws of the three jurisdictions. The exclusion ensures that short-term interbank lending which is typically vital to the operation of a bank and provided by other institutions in the banking system is protected from bail-in. Furthermore, the resolution authorities can exclude other types of liabilities in special cirumstances. Thus, the bank resolution rules create a system whereby debt is 'in or out'[311] in addition to the system under which liabilities are 'up or down',[312] i.e., some liabilities have higher priority ranking than other liabilities.

5.3.4 *Leeway left for national legislatures*

The literature has paid much attention to the fact that the differences between the ranking of claims under national insolvency laws may result in differences in the domestic applications of the bail-in mechanism and make it difficult for creditors to assess the likelihood of their claims being bailed-in.[313] Moreover, scholars have argued that the fact that the BRRD refers to national law to determine the bail-in hierarchy of liabilities may create incentives for national legislatures to design their insolvency ranking of claims in a particular way. For example, they may give a more senior ranking to certain types of debt instruments and, accordingly, reduce the chance that these liabilities are bailed-in to persuade investors to invest in banks in their jurisdiction.[314]

An example of a difference that may arise in bail-in under Dutch, German, and English law relates to tax claims. Given that under the BRRD, liabilities to tax authorities are only excluded from the scope of the bail-in mechanism if the liabilities are awarded a preferential treatment under national law, these liabilities do not fall within the scope of the bail-in mechanism under the Wft but are bail-inable under German and English law.[315]

Position of depositors and deposit guarantee schemes

Article 108 BRRD also illustrates the fact that the Dutch, German, and English legislatures and resolution authorities have some discretion in deciding how to design the hierarchy of claims in bail-in and insolvency. The provision aims to align the position of depositors and deposit guarantee schemes in insolvency with their position in bail-in by requiring the insertion of two rungs to the insolvency ranking of claims under national law.

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311 Ramos Munoz 2017, p. 270.

312 Ramos Munoz 2017, p. 270.

313 Philippon & Salord 2017, p. 44-45; Wojcik 2016, p. 126. *Cf.* Article 10 Winding-up Directive, which provides that the ranking of claims in an insolvency procedure is one of the aspects that is subject to the determination of the law of the bank's home Member State.

314 Wojcik 2016, p. 126.

315 *Cf.* Article 44(2)(g)(iii) BRRD; Letter of the Dutch Minister of Finance of 4 November 2015 (*Kamerstukken II* 2014/15, 34208, no. E).

If under national insolvency law, covered deposits would rank equally with ordinary, unsecured claims, bail-in may result in creditors being entitled to compensation under the no creditor worse off-principle. Covered deposits are excluded from the scope of the bail-in mechanism and, therefore, the class of ordinary, unsecured claims that potentially has to bear losses in bail-in has become smaller. In an insolvency procedure, by contrast, the depositors, or the deposit guarantee scheme subrogating to their rights and obligations, and the ordinary, unsecured creditors would share equally in the available proceeds.[316] This risk that the no creditor worse-off principle is breached in bail-in justifies granting the deposits of natural persons and of micro, small and medium-sized enterprises that are covered by a deposit guarantee scheme a priority ranking in insolvency which is higher than the position of the ordinary, unsecured claims. A deposit guarantee scheme subrogating to the rights and obligations of covered depositors has the same preferred position as the covered depositors. Article 108 BRRD also provides that the part of these deposits that exceeds the coverage level has a ranking below the ranking of the covered deposits but higher than the ranking of the ordinary, unsecured claims.[317] However, the provision does not stipulate how the priority position of depositors and a deposit guarantee scheme should relate to the priority position of other preferential creditors and secured creditors. The literature has noted that the BRRD leaves this to national law.[318]

Under section 212ra Fw the claims set out in article 108 BRRD have a preferential position ('*zijn bevoorrecht*'[319]) and are paid from the proceeds available in a liquidation once the preferential insolvency claims listed in section 3:288 BW have been paid. The latter claims include claims of employees for wages relating to the work performed prior to the commencement of the insolvency procedure. As a result, under Dutch law depositors and deposit guarantee schemes can assert a preferential right but stand at the bottom of the class of preferential insolvency claims and are in a liquidation procedure only paid after the administration claims (*boedelvorderingen*) and all other insolvency claims with preferential treatment.

316 Wojcik 2016, p. 123; Schillig 2015, p. 97.

317 Article 108 BRRD also provides that deposits from natural persons, micro, small and medium-sized enterprises that would be eligible for coverage by a deposit guarantee scheme were they not made through branches located outside the EU of institutions established within the EU have the same priority position as the part of the eligible deposits exceeding the coverage level. For a discussion of Article 108 BRRD, *see also* Haentjens 2017, para. 9.17-9.20.

318 Schillig 2016, p. 366-367.

319 Explanatory Notes to the Dutch Draft BRRD Implementation Act (*Kamerstukken II* 2014/15, 34208, no. 3), p. 128.

Section 46f(4) KWG provides that the claims of depositors and deposit guarantee schemes have priority over the remaining insolvency claims (übrigen Insolvenzforderungen), in the order provided by article 108 BRRD. The present author assumes that the 'remaining insolvency claims' are claims the ordinary insolvency creditors (*Insolvenzgläubiger*) under section 38 InsO. According to the literature, the claims under section 46f(4) KWG should be considered a separate class within the class with claims of insolvency creditors under section 38 InsO and are in a liquidation procedure satisfied after the administration claims under section 53 InsO.[320]

In the consultation procedure on the implementation of the BRRD in the UK, the UK government noted that article 108 BRRD does not prescribe how the position of floating charges in the insolvency ranking of claims should relate to the position of deposits.[321] Some respondents argued that floating charges are typically used by 'sophisticated investors' and should, therefore, not benefit from a more senior ranking than deposits. According to others, however, floating charges are sometimes used by banks for liquidity purposes and providing them a more junior ranking than deposits would deteriorate their value.[322] The legislature decided to create two classes with preferential claims: a class with 'ordinary preferential debts', which include claims of employees, covered deposits and claims of the deposit guarantee scheme, and a class with 'secondary preferential debts', which are the deposits exceeding the amount covered by the deposit guarantee scheme.[323] As a result, in contrast to Dutch and German law, under English law covered deposits and the claims of the deposit guarantee scheme rank equally with other preferential claims, including the preferential claims of employees. Ordinary preferential debts rank above secondary preferential debts. The claims of floating charge holders were not included in the class with secondary preferential debts but rank after this class.

Recent amendments to article 108 BRRD
A new EU directive that amends article 108 BRRD has to be implemented by all EU Member States by 29 December 2018.[324] In the Netherlands a new

320 Skauradszun & Herz 2016, p. 505-508. *See also* Bornemann 2016, para. 49-50.
321 HM Treasury, Transposition of the Bank Recovery and Resolution Directive: response to the consultation, March 2015, para. 2.87-91. *See also* HM Treasury, Transposition of the Bank Recovery and Resolution Directive, July 2014, para. 17.1-9.
322 HM Treasury, Transposition of the Bank Recovery and Resolution Directive: response to the consultation, March 2015, para. 2.87-91. *See also* HM Treasury, Transposition of the Bank Recovery and Resolution Directive, July 2014, para. 17.1-9.
323 Sections 175 and 386 IA 1986 and Schedule 6 to the IA 1986, para. 8-15BB.
324 Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy (OJ L 345, 27.12.2017, p. 96–101). *See also* paragraph 3.2 of chapter 7.

section 212rb Fw has been proposed to implement the amendments.[325] In Germany a new section 46f(6)-(9) KWG entered into force on 21 July 2018.[326] The new article 108(2)-(7) BRRD introduces a specific class of bank debt. The effect is that the class with unsecured, non-preferred bank debt is split into two layers, namely in one lower layer with liabilities meeting the requirements of the new provision and one upper layer with the other senior unsecured liabilities. The lower layer consists of liabilities resulting from debt instruments which contractual documentation and, where applicable, the prospectus explicitly provide that they have the low ranking as defined in article 108(2) BRRD. Accordingly, the resolution authorities can bail-in the financial obligations of a bank that belong to this class immediately after contractually or statutory subordinated liabilities but before the other unsecured, non-preferred claims against a bank. The latter claims include claims that are excluded from bail-in. Because the liabilities in the new class no longer belong to the same class as the excluded liabilities, the authorities can apply their bail-in powers to the new class without treating liabilities in the same class in insolvency unequally in bail-in. The provision also facilitates the compliance of banks with the requirements for a minimum amount of bail-inable debt, i.e., the so-called MREL and TLAC standard, which were discussed in paragraph 3 above.[327] The resolution authorities in the EU require global systemically important banks and may require other banks to meet the requirement for a minimum amount of bail-inable debt with liabilities that rank in insolvency below senior liabilities that are excluded from bail-in or may be excluded from bail-in by the resolution authority.[328]

In September 2018, the UK published a draft version of the Banks and Building Societies (Priorities on Insolvency) Order 2018, which aims to implement the new paragraphs of article 108 BRRD.[329] However, the UK House of Commons' European Scrutiny Committee has indicated that transposition of the directive makes little difference in the UK because the directive does not prevent the BoE from having another preferred approach to the subordination of bank liabilities for the MREL and TLAC requirements, namely structural subordination.[330] Most UK banking groups for

325 Proposal for the Dutch Act to amend the Fw and implement Directive 2017/2399 (*Kamerstukken II* 2017/18, 34909, no. 2).

326 **Gesetz zur Ausübung von Optionen der EU-Prospektverordnung und zur Anpassung weiterer Finanzmarktgesetze (Bundesgesetzblatt Teil I 2018 Nr. 25 vom 13.07.2018).**

327 *See* paragraph 3 above. The requirements for Total Loss-Absorbing Capacity (TLAC) can be found in the 'Total Loss-Absorbing Capacity (TLAC) Principles and Term Sheet' of the Financial Stability Board of 9 November 2015.

328 Article 45b(3) BRRD; Article 12c(1) SRM Regulation; Articles 72a-b and 92a CRR.

329 The draft version of the Order is available at: https://www.gov.uk/government/consultations/draft-banks-and-building-societies-priorities-on-insolvency-order-2018-technical-consultation/technical-consultation-on-the-draft-banks-and-building-societies-priorities-on-insolvency-order-2018

330 European Scrutiny Committee, UK House of Common, Banking reform: risk reduction measures, 27 February 2018.

which bail-in is the preferred resolution strategy have one legal entity within the group, generally a holding company, that issues capital and debt instruments meeting the MREL and TLAC requirements to external investors. The operating subsidiaries within the group, including banks, issue contractually subordinated capital and debt instruments internally to the holding company. The BoE expects to recapitalize the subsidiaries if they experience losses through bail-in of the internally issued instruments. In a winding-up procedure under insolvency law, the claims of the external creditors of the holding company are only satisfied from the proceeds at the subsidiary level after all creditors of the subsidiaries have been paid. Accordingly, these claims at the holding company level are considered to be structurally subordinated to the senior, external liabilities of the operating legal entities, including the liabilities that are excluded from bail-in.[331]

Moreover, although the new article 108(2)-(7) BRRD now aims to harmonize a specific part of the ranking of claims under national insolvency law, the fact that national authorities and legislatures have some leeway in the design of the national bail-in hierarchy of claims is also illustrated by the fact that a similar provision already existed under German law. From 1 January 2017 to 21 July 2018, under the KWG a part of the class of claims of the senior insolvency creditors of banks under section 38 InsO was statutorily subordinated to the remaining claims in the class. The lower layer consisted of claims under certain senior unsecured bank debt instruments, i.e., bearer bonds (*Inhaberschuldverschreibungen*), negotiable registered bonds *(Orderschuldverschreibungen), Schuldscheindarlehen* and non-negotiable registered bonds *(Nahmenschuldverschreibungen)*. Section 46f(5) KWG provided that the payment of these claims in insolvency is conditional on the prior payment of the other claims in the class under section 38 InsO, such as large corporate deposits and claims under derivatives transactions.[332] It is the present author's view that the provision seemed to fit well into German

331 Bank of England, 'The Bank of England's approach to resolution', October 2017, p. 24.

332 The first proposal for Section 46f(5)-(7) KWG of May 2015 explicitly provided for a statutory subordination of the mentioned debt instruments. It provided that the claims are 'als nachrangige Forderungen vor den Forderungen im Rang des § 39 Absatz 1 Nummer 1 der Insolvenzordnung, bei gleichem Rang nach dem Verhältnis ihrer Beträge, berichtigt soweit nicht ein weitergehender Nachrang vereinbart oder gesetzlich vorgegeben ist. Sieht ein vertraglicher Rangrücktritt eine Rangstelle unmittelbar hinter den nicht nachrangigen Insolvenzgläubigern vor, so gilt als vereinbart, dass die Forderungen unmittelbar hinter den Forderungen im Rang des Satzes 1 stehen sollen.' *See* Gesetzentwurf der Bundesregierung, Abwicklungsmechanismusgesetz, Bundesrat, Drucksache 193/15, 1 May 2015, p. 16. Under the provision that entered into force in 2017 the debt instruments are only from an economic point of view treated junior to the other general unsecured claims under Section 38 InsO. Article 46f(5) KWG provides in German that 'Von den Forderungen im Sinne des § 38 der Insolvenzordnung werden zunächst die Forderungen berichtigt, die keine Schuldtitel nach Absatz 6 Satz 1 sind.' *See* Gesetzentwurf der Bundesregierung, Abwicklungsmechanismusgesetz, Deutscher Bundestag, Drucksache 18/5009, 26 May 2015, p. 76-77.

insolvency law, under which several types of claims, including shareholder loans, were already statutorily subordinated by operation of law to the senior unsecured insolvency claims of section 38 InsO.[333] Dutch and English insolvency law, by contrast, do not contain a similar provision under which certain claims are subordinated by operation of law.

Following the entry into force of the BRRD and SRM Regulation, not only Germany but also other EU Member States amended the hierarchy of claims under national insolvency law to facilitate banks to comply with the subordination requirement of the MREL and TLAC standards. The widely accepted view in policy and academic discussions then was that the heterogeneous national approaches to the subordination of bank debt created uncertainty for issuing banks and investors and were likely to complicate the application of the bail-in mechanism to cross-border operating banks. Also, the divergent approaches could cause competitive distortions between banks in the EU internal market. For example, if creditors with otherwise similar debt instruments are treated differently across jurisdictions because of differences in the hierarchy of claims under insolvency law, the costs borne by investors when buying bank debt instruments and costs for banks to meet the subordination requirement are likely to differ.[334] When the EU legislature introduced the harmonized, senior non-preferred debt class, it sought to address these problems.[335]

6 Conclusions

This chapter investigated the objectives, principles, and rules of the national legal frameworks on bail-in established by the BRRD and SRM Regulation. Resolution authorities have the bail-in mechanism at their disposal to write-down and convert into equity capital instruments and liabilities in a certain order, to absorb losses and recapitalize a bank. The paragraphs paid particular attention to the question of how the legal frameworks on bail-in currently interact with and how they have been embedded into private law at the national levels. The sections below summarize the main conclusions of the chapter.

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333 Section 39(1) InsO.

334 E.g., Philippon & Salord 2017, p. 44-46; European Banking Authority, Final Report on MREL. Report on the implementation and design of the MREL framework (EBA-Op-2016-21, 14 December 2016), p. 119; Commission staff working document, Impact assessment accompanying the document Proposal amending the CRR, CRD IV, BRRD and SRM Regulation (SWD (2016) 377 final/2, 24.11.2016), p. 24; Valiante 2016, p. 21-24; Council of the European Union, 'Council Conclusions on a roadmap to complete the Banking Union', 17 June 2016, para. 2.7.

335 *Cf.* Recitals 3-10 Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy (OJ L 345, 27.12.2017, p. 96–101).

1. *Do the national legal frameworks on bail-in and the national company and general insolvency laws share some important principles, especially from the perspective of the trend in the EU to introduce corporate restructuring procedures as an alternative to traditional court-centered procedures?*

Common tendencies in national, corporate restructuring and insolvency laws in the EU include that arrangement that is negotiated amongst the creditors can be imposed on a dissenting minority and that a restructuring procedure can be started at an early stage, i.e., earlier than the moment a formal insolvency procedure can be opened. Dutch, German, and English law all provide for corporate restructuring procedures that are initiated by a plan proposal and end with a court confirmation that can bind dissenting creditors and shareholders to a majority vote. Only English law provides for such a corporate procedure outside the context of a formal insolvency procedure, which is mainly the English scheme of arrangement procedure. In the Netherlands, a proposal for a similar procedure is pending, which is the extrajudicial plan (*onderhands akkoord*) procedure. The bail-in mechanism has both of the two characteristics: bail-in takes place outside a traditional, court-centered insolvency procedure and preferably also at an early stage of financial distress, and the bail-in mechanism is a financial restructuring mechanism that can be used to force creditors and shareholders to accept the restructuring measures. Nevertheless, in contrast to the corporate restructuring procedures, in the application of the bail-in, the financial restructuring is not imposed under an arrangement between the debtor and a certain percentage of its creditors and shareholders and confirmed by a court, but by administrative decision.

2. *What is the effect of a reduction of liabilities of a bank by a resolution authority on the liabilities themselves and related guarantees under national law?*

Write-down and conversion are in the BRRD together referred to as 'reduction'. The BRRD provides that if a resolution authority reduces the principal amount of a liability or outstanding amount payable in respect of a liability, that liability and any obligations or claims arising in relation to it that are not accrued at the time when the power is exercised shall be treated as discharged for all purposes. Also, they shall not be provable in any subsequent procedure in relation to the institution under resolution or any successor entity in any subsequent winding-up. The provision suggests that following bail-in both the principal claim against the bank and a possible indemnity claim of a third party against the bank are to be treated as discharged. It does not exclude the possibility that also a claim of a bank's creditor under a related guarantee is to be treated as discharged. It has been shown that under Dutch law, the likely effect of the debt reduction by the resolution authority is that a surety is then no longer liable to the creditor and the co-debtor no longer for the joint and several obligation (*hoofdelijke verbintenis*) to the extent the liability of the bank is reduced. Under German law, such a debt reduction does not affect the rights of the creditors against the bank's co-debtor, a surety or any other party who is liable for the debtor's obligations. An indemnity claim of these third parties against the bank is treated as discharged to the same extent as the bank's original liability is reduced. Under the UK BA 2009, the BoE seems to have discretion in deciding what are the effects of bail-in on the liability of the bank and related guarantees. However, similar to Dutch law, the general rule under English private law is that the surety is discharged if the principal liability is extinguished by operation of law.

3. *Does conversion of debt into equity under the bank resolution rules follow the formalities and practice for such conversion normally followed in a financial restructuring under national law?*

The BRRD does not prescribe a particular process but requires national law to fill in the technicalities and details of the execution of the conversion. It does require that procedural impediments to the conversion existing under articles of association, contract, or law are removed. Resolution authorities are in principle not subject to requirements to obtain consent or approval from any person, to publish a notice or prospectus, or to file or register a document with an authority. The SAG and its legislative history suggest that the application of the bail-in mechanism under German law follows to a large extent general, national company and insolvency law. The BoE and DNB have both published papers which describe at a high level how the authorities anticipate the conversion process to look like under the BA 2009 and the Wft respectively. The proposed procedures deviate quite significantly from the usual process for conversion of debt to equity under national company and insolvency law and may also differ from the procedures used for bail-in in other jurisdictions. In the procedures, certificates of entitlement or claim rights are provided to the bailed-in creditors, which can be traded until the valuations by the authorities are completed and shares in the capital of the bank can be delivered to the creditors.

4. *How does the hierarchy of claims in bail-in relate to the insolvency ranking of claims under national law?*

The bail-in rules provide for a different system than national insolvency law to protect various types of claims and creditors. The bail-in hierarchy of claims follows to a large extent the hierarchy of claims under national insolvency law. In addition, the resolution rules protect certain types of liabilities of banks by excluding them from the scope of the bail-in mechanism, for example, to avoid that risks spread to other parts of the financial system and enable the bank to continue its daily operations. The rules also empower resolution authorities to exclude other categories of liabilities in exceptional circumstances. Thus, the bank resolution rules combine the system in which some liabilities have higher priority ranking than other liabilities with a policy under which specific types of claims are carved out from bail-in.