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1 Non-judicial insolvency proceedings for banks

1.1 Royal Decree-Law 24/2012, of 31 August 2012 (*RD-Law 24/2012*), could be considered in practice as the insolvency act for credit institutions.

Its content is based on the *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*[1] and the *Memorandum of Understanding* signed by Spain and the Euro group (*MoU*)[2].

The new regulation is based on the public interest in (i) the financial system continuing to work normally regardless of the crisis of a particular bank, (ii) protecting deposit-holders, and (iii) minimising public financial support: shareholders and creditors have to bear losses (bail-in mechanism) before the tax payers takes the strain (bail-out).

1.2 RD-Law 24/2012 introduces three non-judicial or administrative procedures – to be managed by the FROB and the Bank of Spain – for reorganising or winding up banks:

- *early intervention*, of preventive nature and aimed at correcting a bank's course when it is at risk of failing to meet its capital adequacy requirements, keeping it out of insolvency;
- *restructuring,* for those scenarios where a viable bank needs an injection of public funds to overcome liquidity or solvency difficulties; and
- *resolution (*a new term taken from the Proposal for a Directive*)*, conceived for banks that are insolvent or unviable – although so-called systemic banks can be "restructured" rather than "resolved" even if they are unviable.

[1] COM(2012) 280/3 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.
[2] Memorandum of Understanding on Financial-Sector Policy Conditionality dated 20 July 2012.

Early intervention does not involve an injection of public funds, other than in exceptional circumstances, and only in the form of contingent convertible debt ("CoCos") that has to be repaid in two years.

Restructuring is financial (pumping in public money in the form of shares or subordinated debt) and involves assets (transfer of assets and liabilities to an "asset management company" - "bad bank").

Finally, *resolution* involves the orderly winding-up of the entity, transferring its duly restructured assets and liabilities to third parties (a "bridge institution" or "good bank" and to a "bad bank"), and the financial support to the purchaser.

The restructuring and resolution proceedings start with an economic valuation of the institution and all three proceedings with the formulation, approval and implementation of a plan. Banks in *resolution* see their management taken over by the FROB, with this just being a possibility in the other cases. It is interesting to note that if after the financial support the FROB has control over an institution, such control will be exercised in accordance with the rules and mechanisms of Spanish company law.

1.3 The main change brought in by RD-Law 24/2012 lies in the measures targeted at ensuring that shareholders and subordinated creditors bear losses through burden sharing mechanism (known as *management of hybrid and subordinated debt instruments*, which we shall refer to as measures for *restructuring liabilities).*

These measures are essentially discharge of debts and stay of payment of debts (*quita y espera*) taken voluntarily – by the institution – or imposed by the FROB, even against the will or without the consent of those holding the securities. Measures include redemption in part or in whole of the securities or liabilities involved, write-downs of their nominal value or their exchange for other securities. These are the focus of this note.

Protecting the rights of those holding shares and subordinated debt is based on the *economic valuation* of the institution at the start of the procedure, which establishes the floor of what shareholders and creditors will receive.

Shareholders and creditors can challenge the FROB's decisions in administrative proceedings – as a general rule – and in civil procedures - by challenging corporate resolutions and bringing action against directors - when the FROB is acting as the management body of the institution in non-judicial insolvency proceedings.

2 Credit institutions affected

2.1 At the time RD-Law 24/2012 comes into force, there are four groups of institutions in the process of restructuring under the repealed Royal Decree-Law 9/2009: Catalunya Bank, NCG Banco, Banco de Valencia and BFA. Following RD-Law 24/2012, only Banco de Valencia will be

considered as under *resolution*. The other three will be seen as in the process of *restructuring*. Apparently, then, the measures for restructuring liabilities contained in RD-Law 24/2012 may or, as the case may be, must be applied to those holding the shares and subordinated debt of those institutions.

2.2 The results of the stress tests being conducted by Oliver Wyman on 14 banking groups will be published in the second half of September, with the banks put into different categories (0, 1, 2 or 3) as provided for in the MoU. The Bank of Spain, in coordination with the FROB, will then assess the deterioration of each institution with a view to taking, where necessary, the steps for early intervention, restructuring or resolution set out in RD-Law 24/2012. This will make it clear which other institutions will be affected by possible measures for restructuring liabilities.

3 Securities that may be affected

3.1 Securities that could be affected by the described restructuring of liabilities are shares – securities representing capital – and bonds or any hybrid security that is subordinated and whose debtor is the restructured bank, irrespective of whether issued directly or indirectly (through a subsidiary). It looks like other subordinated financing, represented other than through securities, could also be affected.

3.2 Unsecured creditors are not affected by the restructuring liabilities foreseen by RD-Law 24/2012. However, the Proposal for a Directive only safeguards certain types of secured and preferential creditors from these actions (mainly creditors holding secured liabilities, depositors and employees)[3], which makes it likely that the bail-in mechanism in Spain will extend to further securities and debts in the future.

3.3 Shares and subordinated instruments subscribed for by the FROB are also excluded from the measures for restructuring liabilities. However, funds received from the FROB by financial institutions before 31 August 2012 do not, however, share this privilege[4].

4 Limits on powers for mandatory restructuring liabilities: priority of payment in cases of liquidation

4.1 Subordinated creditors will follow shareholders in bearing the losses from restructuring or resolution in the order of payment laid down in Spanish insolvency legislation. Holders of shares will therefore be the first to bear losses, followed by holders of preference shares (*participaciones preferentes*) and then providers of subordinated

[3] In the Proposal for a Directive, the scope of the bail-in tool includes all claims against the failing institution except for a number of specific debts, notably deposits and secured liabilities, a category in which Spanish covered bonds and mortgage bonds ("*cédulas hipotecarias*" and "*bonos hipotecarios*") would have to be included (the Proposal for a Directive does, however, permit Member States to extend the scope of the bail-in to the part of a secured liability that exceeds the value of the collateral against which it is secured). In any cases, in the event of resolution, foreclosure of mortgage bonds – and of covered bonds – could be affected by the FROB's powers to suspend the enforcement of security interests "for the limited period of time that the FROB considers necessary to achieve the resolution aims".

[4] Section 3 of the third transitional provision of the RD-Law.

financing in order of priority, and higher-ranked instruments cannot take any losses until lower-ranked claims have been totally cancelled.

4.2 In the context of mandatory restructuring of liabilities, RD-Law 24/2012 contains a reference to the "proportional" allocation of losses with regard to holders of higher-ranked securities. However, this reference would not appear to mean anything other than that already stated: that higher-ranked instruments cannot be affected until lower-ranked claims have been totally cancelled. This can also be deduced from the fact that no similar reference can be found in the Proposal for a Directive.

5 Limits on powers for restructuring liabilities: market value of instruments involved; entitlement to payment of no less than that in an insolvency proceeding

5.1 Investors whose assets are subject to measures for restructuring liabilities taken during resolution or restructuring will be entitled to payment of an amount *no less* than the payment to creditors they would have received if the institution had been liquidated through insolvency proceedings. To calculate this "contrafactual" element, the point of reference has to be the economic valuation of the institution that has to be completed at the beginning of the process.

5.2 *Voluntary* measures for restructuring liabilities have to be settled at the *market value* of these claims, applying the premiums or discounts that are in accordance with EU rules on State aid (what an "outside investor" would pay). Institutions have to request at least one independent expert report to support this market value.

The MoU advises against institutions that receive public funds making exchange offers to their subordinated creditors on excessively favourable terms and, for that purpose, a cap has been put in place: the market value of the exchanged asset plus 10% of the security's nominal value. This reference has not been included in RD-Law 24/2012.

5.3 If the FROB takes steps for the mandatory restructuring of liabilities, the rule of assessment is, in principle, the same, but market value is set as a "cap", with the floor being the amount that the shareholders or creditors would receive as payments to creditors in an insolvency proceeding. That amount would be determined by the economic valuation of the institution that has to be completed at the beginning of the process.

6 Mechanisms for claims and challenges against incorrect use of powers for restructuring liabilities

6.1 The decisions taken by the FROB as the management body for the institution in restructuring can only be challenged in the Spanish commercial courts (*Juzgados de lo Mercantil*) within 15 days and provided that the actions are unlawful (decisions that go against the institutions' articles of association or corporate interest cannot be

challenged), irrespective of whether the FROB has liability for damages caused to shareholders, creditors or others in general. The so called corporate action for liability (*acción social de responsabilidad*) cannot be brought against the FROB.

6.2 The FROB's decisions in the exercise of its administrative powers are *administrative actions* that can be challenged in the administrative chamber of the Spanish *Audiencia Nacional* within two months after they are made "public". Challenges can be lodged by parties holding 5% of the issued share capital and holding the instruments subject to liability restructuring actions as well as the *comisario* or bondholders' representative. It will often not be reasonably possible to enforce rulings in which challenges are upheld on their own terms – voidance of the administrative action – so enforcement is expected to take the form of compensation.

Challenges could be grounded upon the unconstitutional nature of the RD-Law (casting doubt on the constitutionality of the measures for restructuring liabilities imposed by the FROB when taken as part of a restructuring process, and not in resolution) and the illegality of specific decisions made (breaking the specific rules that the FROB has to follow in using its powers or because the FROB exceeds its discretional limits in this area).

In ant event, successfully challenging the decisions made by the FROB may not be easy. As administrative actions, the legality of the FROB's decisions will be a rebuttable assumption (*iuris tantum*), which places the burden of proving that they are unlawful on the parties who challenge them. In practice, the courts have been fairly shy and self-contained in controlling discretionally powers such as those given to the FROB in RD-Law 24/2012.

6.3 Finally, it is interesting to note that RD-Law 24/2012, according to the rules on conflicting governing laws, might also not be applicable to – and creditors unaffected by – issues of securities or debt arrangements subject to foreign law.

7 Other aspects of RD-Law 24/2012 that could affect liabilities and instruments issued by credit institutions

7.1 RD-Law 24/2012 gives the FROB certain general powers to impose a suspension on agreements and security interests:

(i) the power to suspend any payment or delivery obligation under any agreements entered into by the institution (with the exception of deposits) for a maximum period that starts on the date the exercise of the powers is made public and ends, at the latest, at five pm on the following business day; and

(ii) the power to prevent or restrict – in a *resolution* procedure – enforcement of security interests against any of the institutions' assets for the limited period of time that the FROB considers necessary to fulfil the aims of the resolution. As this is a power for a "suspension", it would have to be exercised by the FROB before the obligation is discharged or payment made.

7.2 RD-Law 24/2012 also lays down specific rules relating to *derivative transactions,* or more specifically to the obligations of credit institutions subject to early intervention, restructuring or resolution under financial transactions and contractual netting agreements to which Royal Decree-Law 5/2005 is applicable.

The FROB can suspend, until five p.m. on the following day (after the use of its power is made public), the right of the counterparties to declare the early termination of such obligations or to enforce or offset them, on the grounds of the adoption of early intervention, restructuring or resolution.

For failing banks under resolution, RD-Law 24/2012 also excludes the ability of counterparties to early terminate, enforce or set-off where the corresponding transactions have been transferred to a "bridge institution" or other third party. This rule, in principle, only applies where the early termination or enforcement rights are based on the resolution measure or the transfer of the transaction agreed by the FROB, but not in scenarios where early termination, enforcement or set-off are due to an event of default occurred before and unrelated to the transfer.

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