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The US View Of Non-US Regulatory 'Bail-In' Powers

Law360, New York (January 31, 2013, 6:58 PM ET) -- The European Commission, the Financial Stability Board (FSB), the Independent Commission on Banking (Vickers Commission) and other bodies have suggested "bail-in" as a method of resolving the affairs of large, systemically important financial institutions (SIFIs) facing insolvency or other crisis.[1] Thus far, only Spain and Switzerland have adopted restructuring laws contemplating this method[2], but many more European nations are likely to do so in the coming years, as EU member states are required to achieve "substantial compliance" with the proposals by 2018.[3]

Bail-in allows the home regulator of a troubled SIFI to convert certain classes of debt of the SIFI into equity in the SIFI without the debt holders' consent. In theory, a troubled SIFI with dwindling capital and related capital ratios can, at the stroke of a pen, have its capital and related capital ratios significantly enhanced, thereby bolstering market confidence in its viability. In particular, while bail-in does not contemplate infusions of new equity, its implementation may stem the tide of margin calls that otherwise would be triggered by depleted capital.

The operations of most SIFIs, however, are not limited to their home countries. Rather, they have global operations, and the debt issued by their holding companies or operating subsidiaries may be governed by U.S. law, including, in the case of bonds, the Trust Indenture Act (TIA)[4]; may be held by investors outside the home country; and may contain venue provisions requiring that litigated disputes be adjudicated in courts outside a SIFI's home country. Accordingly, one question raised by the bail-in remedy is the extent to which courts outside a SIFI's home country may recognize and respect the remedy.

Outside the SIFI context, it has not been uncommon for holders of debt issued by companies subject to non-U.S. insolvency proceedings to attempt to collect on that debt in U.S. courts notwithstanding the pendency of such insolvency proceedings.[5]

There are two ways that matters concerning recognition of a non-U.S. restructuring proceeding can be brought before a U.S. court. First, a foreign representative of an entity subject to non-U.S. insolvency proceedings may file a petition under Chapter 15 of the U.S. Bankruptcy Code.[6] If the petition is granted and the foreign proceeding is recognized, then the non-U.S. debtor is entitled to many of the protections of the Bankruptcy Code, including the benefit of a stay against efforts by creditors to exercise remedies in the United States.[7] Chapter 15, however, may not be available to all SIFIs, as foreign banks are precluded from filing bankruptcy in the United States[8] (see "Expanding Use of Chapter 15 Tests Its Protections and Limits").

As an alternative to Chapter 15, U.S. creditors may attempt to enforce their rights under their debt instruments in U.S. courts. As noted above, debt instruments commonly have U.S. choice-of-law or venue provisions, and the TIA generally prohibits, outside of Chapter 11, nonconsensual modification of a bondholder's debt maturity and payment terms.[9]

Accordingly, U.S. creditors may invoke TIA provisions to seek U.S. court assistance enforcing the original terms of debt that have been restructured in a foreign proceeding. As a general matter, U.S. courts dismiss such actions, based on principles of international comity, if the claimant fails to establish prejudice or injustice as a result of the non-U.S. insolvency proceeding.[10]

There are limits, however, to how far a U.S. court will go in recognizing non-U.S. insolvency proceedings that are contrary to U.S. law. A U.S. court will recognize a non-U.S. insolvency proceeding that is unlike a U.S. insolvency proceeding, but the non-U.S. proceeding cannot violate basic notions of fairness. The U.S. Court of Appeals for the Fifth Circuit recently refused to recognize a Mexican insolvency proceeding of a parent holding company that purported to discharge the guarantee obligations of the company's U.S. nondebtor subsidiaries.[11] U.S. courts are split on the propriety of such releases and will enforce them only in extraordinary circumstances.[12] Because the Mexican debtor did not satisfy these U.S. standards, the Fifth Circuit refused to authorize the releases (see "Expanding Use of Chapter 15 Tests Its Protections and Limits").

There is no precedent for a U.S. court recognizing a non-U.S. regulator's unilateral bail-in conversion of a non-U.S. SIFI's debt to equity. If a non-U.S. SIFI were to face a crisis and its debt were in fact converted, U.S. holders of such debt could be expected to challenge the propriety of such bail-in in U.S. courts. While Chapter 11 allows U.S. debtors to reorganize their affairs, among other things, swapping debt for equity much like bail-in, Chapter 11 reorganization plans cannot be confirmed without some indicia of requisite creditor support.[13] Generally, impaired creditors are entitled to vote to accept (or reject) a Chapter 11 plan. The plan is not accepted by creditors of a class unless at least one-half of the creditors voting, holding at least two-thirds in dollar amount of claims, accept the plan.[14]

Chapter 11-like procedural and substantive protections for creditors are nonexistent in a regulatory bail-in. In bail-in, a non-U.S. SIFI's debt may be converted to equity without any advance notice to, input from or assent by holders of the debt instruments being converted to equity. Arguably, this is a fundamental lack of due process for creditors that is so contrary to U.S. policy that a U.S. court should not recognize the non-U.S. regulator's use of the bail-in remedy.

However, strong countervailing considerations suggest that a U.S. court faced with a challenge by a U.S. holder of debt bailed-in by a non-U.S. regulator may dismiss the creditor challenge and recognize the non-U.S. bail-in remedy. While Chapter 11 contemplates creditor due process and participation, there are two other significant U.S. insolvency regimes that, like bail-in, vest considerable authority in U.S. regulators to act swiftly, with little or no input from creditors or other stakeholders. The rationale behind these U.S. laws, like bail-in, ultimately is to protect the public interest.

One such law is the Federal Deposit Insurance Act (the FDIA).[15] Under the FDIA, a bank can be resolved by the Federal Deposit Insurance Corporation (FDIC) with no advance notice to or assent by the bank's creditors — including by transfers of selected assets to a purchaser or "bridge bank."[16] There is a very long history in the U.S. of banks being resolved rapidly — even over a weekend — under the FDIA. This regime, in short, vests great authority exclusively in the hands of the FDIC, much like bail-in.

Likewise, Dodd-Frank contains a new insolvency regime exclusively for large, systemically important financial institutions.[17] Dodd-Frank was enacted in response to the 2008 financial crisis. Under this regime, known as the "Orderly Liquidation Authority," the FDIC may be appointed as receiver of a financial company with virtually the same powers as it has under the FDIA with respect to U.S. banks.[18] Again, such powers may be exercised with no advance notice to, or input from, creditors or other stakeholders. While such powers do not explicitly include the authority to unilaterally convert debt to equity, such

powers are implicit, e.g., if the FDIC transfers the institution to a bridge bank, it can later distribute equity in the bridge bank to holders of the bank's debt.

Accordingly, U.S. courts might ultimately conclude that foreign regulatory bail-in of an insolvent foreign SIFI is consistent with U.S. law and public policy. Indeed, bail-in is one of many pieces of legislation (including Dodd-Frank) enacted by numerous countries following the financial crisis that vests home regulators with the significant, centralized authority to act swiftly to avoid or mitigate a national, economic catastrophe. Accordingly, a U.S. court facing a challenge to non-U.S. bail-in likely would be very reluctant to second-guess a determination made by duly constituted, non-U.S. regulatory authorities, that such authorities needed to implement extraordinary bail-in measures in an effort to maintain economic and social stability.

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[1] 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, COM (2012) 280 final, 2012/150 (COD) (June 6, 2012); Recovery and Resolution Planning: Making the Key Attributes Requirements Operational (Financial Stability Board), Nov. 2, 2012; Final Report and Recommendations of Independent Commission on Banking, Sept. 12, 2011.

[2] The Swiss bail-in statute is codified in the Swiss Banking Act, Arts. 28-32. The Spanish bail-in statute was enacted through Royal Decree-Law 24/2012 of Aug. 31, 2012.

[3] See 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, at Art. 114, COM (2012) 280 final, 2012/150 (COD).

[4] 15 U.S.C. §§ 77aaa-77bbbb.

[5] See ABN Amro Bank N.V. v. Parmalat Finanziara S.p.A., 394 B.R. 696 (S.D.N.Y. 2008) (affirming permanent injunction against attempts to collect on debt that was restructured in Italian insolvency proceeding).

[6] See 11 U.S.C. §§ 1504, 1515.

[7] See 11 U.S.C. § 1520.

[8] See 11 U.S.C. § 1501(c).

[9] See 15 U.S.C. § 77ppp(b).

[10] See Finanz AG Zurich v. Banco Economica, 192 F.3d 240, 246 (2d Cir 1999).

[11] See Judgment, Ad Hoc Grp. of Vitro Noteholders v. Vitro SAB de CV, No. 12-10542 (5th Cir. Nov. 28, 2012).

[12] See, e.g., Deutsche Bank AG v. Metromedia Fiber Network, Inc., 416 F.3d 136, 141-43 (2d Cir. 2005) (describing extraordinary cases in which nondebtor releases are available).

[13] See 11 U.S.C. § 1129(a).

[14] See 11 U.S.C. § 1126.

[15] 12 U.S.C. § § 1811-1831aa.

[16] See 12 U.S.C. § 1821(n).

[17] Pub. L. 111-203 (codified as amended in scattered sections of U.S.C.).

[18] See 12 U.S.C. § 5390.

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