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Briefing note

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European Court gives guidance on the winding up directive for banks

On 17 October 2014 a European Court in the case of Landsbanki hf v Merrill Lynch International Limited provided some much needed guidance on protecting the legitimate expectations of creditors and third parties for transactions entered into prior to the winding up or reorganisation of a bank. The case considers how acts entered into before a bank's winding up or reorganisation may be defended against challenges raised within those proceedings.

Key issues

- First European case on scope of defences to avoidance claims under WUDB
- Clearer and more predictable regime
- Defences apply to bankruptcy and non bankruptcy challenges
- Proof of no actual challenge available in governing law protects from avoidance action in winding up or reorganisation proceedings
- Potential wider application under EUIR and WUDI

What's all the fuss about?

It is hardly surprising that the fallout of the Icelandic banks has provided the greatest source of jurisprudence on the European Winding Up Directive for banks. To date, this has been at a national court level. In this briefing we consider a new decision from the European Free Trade Association Court (the EFTA Court). The EFTA Court rules on disputes between EFTA states, namely Iceland, Norway and Lichtenstein, in relation to matters in the European Economic Area.

Article 30 is one of the key provisions of the EC Directive on the reorganisation and winding up of credit institutions (the Directive). It provides an exception to the rule that the law where the credit institution is being wound up or reorganised, governs the ability to challenge acts detrimental to all creditors (see Article 10 of the Directive). It states that where there is a different governing law in relation to a particular act, and that governing law does not provide any means of challenge, then the transaction cannot be held to be void, voidable or unenforceable. The purpose of the exception is to protect creditors or third parties who have entered into arrangements with a credit institution, have chosen a particular governing law, and expect for that law to apply notwithstanding any winding up or reorganisation (for a reminder and overview of the principles of the Directive – see explanation box below).

Roger Best, partner in the litigation and dispute resolution group, heralds the decision: *"It provides very welcome guidance on Article 30 as a means of defending an avoidance action. It is an area that has always proved problematic and less useful in practice than we assumed was originally intended. The guidance in this case gives greater clarity on the meaning of this important exception. It may make it more useful to rely upon in the future."*

The case may also be of broader application, as there are almost identical provision contained within the European Regulation on Insolvency Proceedings (the EUIR) and the European Directive on the Reorganisation and Winding Up of Insurance Undertakings (WUDI). Importantly, in this case the EFTA Court held that the types of challenges to which the exception applies are very wide – they are not limited to contract law but also extend to other laws, including insolvency law challenges. In addition, the EFTA Court held that the detrimental act not only had to be capable of being challenged in principle, but there had to be an assessment of the specific case in hand. Defences to such challenges brought in the winding up

and reorganisation proceedings of the home member state can be found in the applicable governing law and relied upon from both a procedural and substantive law perspective.

Adrian Cohen, partner in the restructuring and insolvency group, comments: *"The decision is good news generally, but especially for secured creditors. They not only benefit from a carve out for security rights located outside of the home member state, but this case now signifies the start of a more predictable regime relating to the potential challenges applicable to those security rights. In this respect, as long as the arrangements are governed by another law which does not permit any actual means of challenge, they will be able to rely on this as a defence to challenges brought in the winding up and reorganisation proceedings."*

What does Article 30 say?

Article 30 states that the home member state's rules do not apply where the beneficiary of the act provides proof that:

1. the act detrimental to the creditors as a whole is subject to the law of a member state other than the home member state; and
2. that law does not allow any means of challenging that act in the case in point.

What does the case say about it?

In *Landsbanki hf v Merrill Lynch International Limited*, the alleged detrimental act arose in the context of the collapse of Landsbanki Islands hf (Landsbanki), which is now in an Icelandic winding up proceeding. Shortly before the collapse, payments were made to Merrill Lynch International Limited (MLI) in return for the sale to Landsbanki of bonds that it had itself issued. Landsbanki sought rescission of the payments which would be challengeable under the provisions of Icelandic bankruptcy legislation. It was not in dispute that the transactions were subject to English law. Landsbanki brought an avoidance action in the Icelandic court and, at MLI's request, the court sought an advisory opinion from the EFTA Court on the interpretation of Article 30.

The EFTA Court found that "voidness, voidability or unenforceability of legal acts" was to be interpreted widely. The test was whether the act was detrimental to the general body of the creditors as a whole. Consideration by the court in relation to the scope of challenges and the application of the exception were held not to be limited to contract law, nor were they limited to insolvency law. They included avoidance rules arising as a result of the bankruptcy proceedings. Furthermore, it was held that beneficiaries of the acts complained of could rely on both substantive and procedural reasons to prove that there was no possibility, or no longer a possibility, to challenge the act in question. So, for example, it would be a sufficient defence to show that the relevant time limit had expired, which meant that there was no longer a possibility to challenge the act. Giles Allison, the senior associate who acted on behalf of MLI, addressed the EFTA Court on the relevant English law issues. In addition, it was held that it is not sufficient to determine the mere possibility of challenge in the abstract. A detailed assessment of the specific act must be undertaken and it is not sufficient that the act can "in principle" be challenged, unless, as a matter of fact, it would be successfully challenged. In this regard, Article 30 provides a defence to the beneficiary if it can prove that the requirements for such a challenge are not in fact satisfied. This proof must be assessed in accordance with the rules of the home EEA state for determining the substance of the foreign law (i.e. where the winding up or reorganisation is taking place).

Why does it matter?

It is the first time that Article 30 has come before a European Court. Since the inception of the Directive and the equivalent provision in the EUIR, their usefulness as an exception to the general avoidance rules has always been hindered by a lack of clarity as to how effective the defence can be. The decision underlines the fact that the legislation (both the Directive and the EUIR) respects the rights of parties and their choice of governing law in relation to pre-insolvency arrangements. In the event of intervening insolvency, the transactions governed by and valid under the laws of another jurisdiction ought not to be displaced due to some arbitrary differences in the rules applicable in the home member state where the insolvency or reorganisation proceedings may be taking place.

The judgment provides very welcome guidance on this key aspect of cross-border insolvency law, in particular, that the pre-existing rights ought to be protected in accordance with the governing law applicable to those rights. Even though the judgment may not come as much of a surprise, it will be seen as providing much needed clarity on this issue - especially when it comes to structuring transactions and providing legal opinions on contracts that are subject to different laws (in particular, where acts are governed by a law different to the law of the insolvency or reorganisation proceedings). In this case, the governing law of the act was not

under dispute, but this may not always be so straightforward and the case does not offer any significant guidance in this regard. Generally speaking, the nature of the act will provide connecting factors, which will link the act to a particular legal system (for example, the creation and exercise of rights under a contract will be governed by the proper law of the contract; the performance of obligations under a contract is linked to the proper law of the contract and the law of the place of performance; and the grant of a security will be governed by the law of the location of the property and the proper law of the contract). So, for example, secured creditors with security located outside of the home member state, who may also benefit from a carve out from the effects of the winding up or reorganisation proceedings, may equally take some comfort from the fact that a risk of potential challenge to that security under Article 10 of the Directive can be minimised (so long as they can demonstrate that another law applies, and that such law would not allow a means of challenge).

The judgment clearly holds that the mere possibility of a challenge "in principle" as a matter of general law (including insolvency law) is not sufficient. Giles Allison notes: "*If the beneficiary can prove that, on the basis of substantive or procedural law, or on the particular facts, the criteria for such a challenge are not met in relation to the governing law rules, then the transaction in question will be protected from the effects of the challenges arising out of the winding up or reorganisation proceedings. Therefore, it may be easier to defeat a challenge if there is a substantive or procedural basis for excluding the challenge altogether. Even where there is a theoretical possibility of a challenge, this may be defeated as a matter of fact in any given case".*

The decision means that the importance of jurisdictional discrepancies in the treatment of challenges under insolvency or reorganisation regimes is diminished, and more emphasis will now be put on the governing law of the act in question. Of course, the decision will not affect those acts which are, as a matter of fact, governed by the law of the home member state where the winding up or reorganisation is taking place. In such cases, those transactions will continue to be subject to the rules of the home member state where the proceedings are taking place.

The case also highlights how different member states (in this case Belgium) and representative bodies (in this case the EU Commission and the EFTA Surveillance Authority) had very different views on how the exception in Article 30 ought to be interpreted. Furthermore, it appears from the judgment that Article 99(2)(n) of the Financial Undertakings Act, which was intended to implement Article 30 of the Directive in Iceland, is not necessarily consistent with the Directive. It was submitted by Landsbanki in this case that the Financial Undertakings Act is seeking to limit the disapplication of Icelandic law under the Directive only to rescission in accordance with the Act on Invalid Legal Instruments. This would mean that the exception would not apply to avoidance actions under the Icelandic bankruptcy legislation. This was rejected by the EFTA Court and held to be inconsistent with the terms of the Directive.

It also appears that Iceland may not have been alone in its erroneous transposition of the Directive. The English implementation of the Directive, namely The Credit Institution (Reorganisation and Winding Up) Regulations 2004, provides at Article 30(2) that "the rules relating to detrimental transactions mean any provision of the *general law of insolvency* relating to voidness...etc," which is, again, a limitation on the type of law not found within the Directive itself and that was in fact specifically rejected by the EFTA court.

Amendments to the Directive have been proposed as a result of the Directive on Establishing a Framework for the Recovery and Resolution of credit institutions (BRRD) and investment firms published in the official journal in June this year. These amendments, however, do not encompass any changes to the substance of the exceptions to the governing law rules.

Does the case have a broader application?

Whilst the Directive is not identical to the EUIR and WUDI in all respects, in relation to potential challenges, the provisions of Article 30 of the Directive and Article 13 of the EUIR and Article 24 of WUDI are almost equivalent. In that regard, the decision is also welcomed from the perspective of those pieces of legislation. It should be noted that whilst the decisions of the EFTA Court are not binding on EU courts, they are highly persuasive on areas where there is legislative overlap.

There is a case pending before the European Court of Justice, *Lutz v Bauerie* C-557/13, which raises similar questions of interpretation in respect of Article 13 of the EUIR, and in particular in relation to the relevant time periods applicable to such challenges. It will be interesting to see whether that court is informed by the guidance of the EFTA Court in the Landsbanki case.

The EUIR is also currently undergoing

an amendment process; however the proposed changes do not include anything to clarify the ambiguities of Article 13.

The Icelandic firm Jonatansson and Co. Legal Services and Clifford Chance LLP represented MLI in this case.

The key principles of the Winding Up Directive

Unitary Approach

The Directive (which has been transposed into national law in each of the EU member states and the EFTA states) provides that in relation to a credit institution and its branches, only the home member state (i.e. place where the institution is regulated) is allowed to implement a winding up or reorganisation process. The unitary proceedings are then recognised and given effect without further formality in each of the member states.

For example, in this case, Landsbanki's winding up in Iceland is recognised in the EEA states and no other winding up proceedings can be commenced against it in other EEA states.

Which law applies?

It is then the law of the home member state that governs key aspects of the winding up or reorganisation process (i.e. the determination of assets which form part of the estate; the effects of the proceedings on creditors; the ranking of claims; and the rules relating to avoidance actions). The Directive does, however, provide for certain exceptions to the general rule that the law of the home state applies. These include, for example, employment contracts for employees located outside of the home member state, or security rights for security located outside of the home member state. Therefore, in this case, the winding up proceedings in Iceland will determine how creditor claims are ranked. But employees of the Icelandic bank based in the UK will have their rights governed by the UK legislation. For the full extent of the exceptions to the governing law of the home member state, see Articles 20 to 27 and 29 to 32 of the Directive.

Article 30 exception (Detrimental acts)

Article 30 provides one of the exceptions. It relates to potential challenges that can arise in relation to acts that took place before the winding up or reorganisation. It also disapplies the effect of the home member state rules on avoidance actions, if the acts complained of are governed by another law and that law offers no basis for challenge.

National law implementation

The Directive requires member states to transpose it into their national laws. In England, it takes the form of Credit Institutions (Winding Up and Reorganisation) Regulations 2004. Iceland acceded to the Directive and has implemented it in the form of the Financial Undertakings Act.

Future amendments

Amendments to the Directive are due to be implemented as a result of the BRRD (Directive 2014/59/EU on establishing a framework for the recovery and resolution of credit institutions and investment firms before 31 December 2014). Essentially, the amendments provide that the winding up directive be extended to investment firms and, in the event of the application of the resolution tools, to financial institutions, firms and parent undertakings. In addition, various definitions have been updated so that they are consistent with the European Regulations on prudential requirements for credit institutions and investment firms (CRR) and the Directive on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV).

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