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INFORMATIVE NOTE

DISPUTE RESOLUTION

The no creditor worse off principle in the resolution of insurers

The proposal for a directive on the recovery and resolution of insurance and reinsurance companies enshrines the no creditor worse off principle as provided for in the Bank Recovery and Resolution Directive ("BRRD"). This opens the door for the Portuguese legislature to repeat the mistakes it made when incorporating the BRRD into Portuguese law.

Nevertheless, the legislature's job will be to provide the following – with no room for ambiguity:

i) The shareholders of the company undergoing resolution are the first to bear the losses in resolution;

ii) Creditors of the firm undergoing resolution bear losses after the shareholders, in accordance with the ranking of their claims in normal insolvency proceedings;

iii) Loss absorption by shareholders or creditors must not be disproportionate or discriminatory;

iv) No creditor should incur greater losses in the resolution than if the firm undergoing resolution had been wound up in normal insolvency proceedings;

v) Member States are required to ensure that an independent valuation is carried out as soon as possible after the resolution action (or actions) take effect. It is suggested that the timing of this valuation should be specified in the national law.

No creditor should incur greater losses in the resolution than if the firm undergoing resolution had been wound up in normal insolvency proceedings.

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The legislature intended to determine that the shareholders of the company subject to resolution are the first to bear the losses – whatever they may be – in the resolution.

The European Commission published its proposal for a directive on the recovery and resolution of insurance and reinsurance undertakings ("Proposal")[1] on 22 September 2021. This follows in the footsteps of the now well-known Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014[2] ("Bank Restructuring and Resolution Directive" or "BRRD2), which applies to the banking and financial sector. In fact, the European Commission done little more than copy and paste the bank resolution rules, so there is a pressing need to determine whether the problems raised by the BRRD still exist and whether they will be carried over to the insurance sector.

The general principles that govern insurance companies have also been maintained by the European legislature in Article 22 of the Proposal, which copies Article 34 of the BRRD in almost its entirety. We will focus on the enshrinement of the no creditor worse off principle ("NCWO") in the Proposal and, in doing so, we will focus on comparing it with the rules already established for bank resolution.

The Proposal provides that "*the shareholders of the undertaking under resolution bear first losses"*[3]. This raises the first problem: there is enough doubt for the interpreter to wonder what "first losses" are. It is clear that the official translation of the Proposal into Portuguese was not the best. However, when compared with the English version of the Proposal and with Article 34 of the BRRD, it is clear that the legislature intended to determine that the shareholders of the company subject to resolution are the first to bear the losses – whatever they may be – in the resolution. This then implies, for example, that the national resolution authority could transfer the shares or all or part of the assets of the insurance or reinsurance company undergoing resolution to a private purchaser without the consent of the shareholders, as is the case under the BRRD.

In turn, "*creditors of the undertaking under resolution bear losses after the shareholders in accordance with the order of priority of their claims under normal insolvency proceedings*"[4]. This means, as under the BRRD, that the national resolution authority can determine that only some liabilities[5] are transferred from the resolved company to a purchaser or bridge institution, or written down or converted to equity. In other words, one can differentiate between creditors.

1 Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of insurance and reinsurance undertakings and amending Directives 2002/47/EC, 2004/25/EC, 2009/138/EC, (EU) 2017/1132 and Regulations (EU) 648/2012.

2 See Official Journal of the European Union (OJ), L 173, 12 June 2014, p. 190.

3 See article 22(1)(a) of the Proposal.

4 See article 22(1)(b) of the Proposal.

5 Respecting the conditions set out in the Proposal to determine these liabilities.

However, the absorption of losses by shareholders or creditors cannot be disproportionate or discriminatory, and the legislature has enshrined important exceptions and limits reflecting this concern[6]. First, the power to transfer and re-transfer given to the national resolution authority in respect of security arrangements, set-off arrangements, netting arrangements, unit-linked policies or other ring-fenced portfolios, reinsurance treaties and structured finance arrangements is limited[7]. Second, the principle that no creditor should bear higher losses in the resolution than if the company under resolution had been liquidated under normal insolvency proceedings is safeguarded. This second exception is known - as mentioned above - as the principle of "no creditor worse off". This derives from the principle of equal treatment of creditors[8], which, in turn, was already consecrated in Roman Law (*par conditio creditorum*) and incorporated into the Portuguese Civil Code[9]. It is a cornerstone of the principle of financial responsibility and, consequently, of bankruptcy rules.

The NCWO principle as enshrined in the Proposal[10] is in keeping with the way the European legislature enshrined it in the BRRD[11]. Here too, it obliges Member States to ensure that an assessment is carried out by an independent person as soon as possible after the resolution action (or actions) have taken effect.

It is the legislature's intention to avoid damage to the legal sphere of creditors due to the delay in carrying out the valuation.

Regarding this application of the principle, we would highlight two essential elements: the substantive element and the element of timing that appear in Article 54 of the Proposal. The European legislature has (i) determined the values to be calculated by the independent person and the basis on which the calculation should be made[12], and (ii) defined that the valuation will have to be concluded as soon as possible after the resolution action takes effect. This makes it clear that the intention of the legislature was to avoid any losses for creditors resulting from a delay in carrying out the valuation. Otherwise, if the delay is attributable to the resolution authority, it will itself be responsible for compensating creditors for any losses caused by the delay. Moreover, for the purposes of incorporation into the Portuguese legal system, it is suggested that the legislature should specify when the compensation is to be paid, in order to protect creditors, as the disadvantaged party in the liquidation process.

6 Chapter V of the Proposal.

7 See articles 57 to 60 of the Proposal.

8 Armindo Ribeiro Mendes, "A resolução e outros mecanismos de intervenção em instituições de crédito à luz da Constituição", in *III Congresso de Direito da Insolvência*, Catarina Serra (Org.), Coimbra, Almedina, 2015, pp. 23-60 (49).

9 See article 604(1) of the Portuguese Civil Code ("CC").

10 See articles 53 to 55 of the Proposal.

11 See articles 73 to 75 of the BRRD.

12 Furthermore, EIOPA will prepare draft technical standards to regulate the specific methodology for carrying out the valuation, which the Commission may adopt in the future – see Article 54(4) of the Proposal.

In this regard, however, note what happened in the incorporation of the rules on the NCWO valuation in the BRRD into Portuguese law... Like the Proposal, the BRRD provides, and provided at the time, that the valuation should be performed as soon as possible after the resolution action has taken effect. However, in the first partial implementation of the BRRD[13], the General Framework for Credit Institutions and Financial Companies (*Regime Geral das Instituições de Crédito e Sociedades Financeiras* –"RGICSF") postponed this valuation until the end of the liquidation of the credit institution subject to resolution. This constituted a profound and significant breach of the objectives of bank resolution as set out in the BRRD. Furthermore, it breached all the duties incumbent on Member States in the implementation and incorporation into national law of directives, and, in particular, the attempt by the European legislature to avoid greater (and unnecessary) damage to the legal sphere of creditors affected by the resolution.

The independent valuer determines whether the treatment of creditors resulting from the resolution action will (or will not) put them in at least the same position as they would be in if they were dealt with under normal insolvency proceedings.

There is no doubt that a full resolution and liquidation process of an insurance or reinsurance undertaking or, worse, of an insurance group, would take many years, even decades. Therefore, it is unacceptable for the Portuguese legislature to force creditors to wait that long to receive the compensation resulting from the NCWO principle. We therefore hope that the mistakes made in the past in incorporating the BRRD into Portuguese law will not be repeated.

It follows that the valuation must then determine whether the shareholders and creditors of the insurance or reinsurance company subject to resolution would have received more favourable treatment if the company had entered, directly and as a whole, into normal insolvency proceedings. Accordingly, the independent valuer determines whether the treatment of creditors resulting from the resolution action will (or will not) put them in at least the same position as they would be in if they were dealt with under normal insolvency proceedings. The valuer also determines what difference (if any) there is between one treatment and the other.

If such a difference exists, Member States are obliged to ensure that the shareholder, creditor or insurance guarantee scheme is entitled to the payment of the difference[14]. Compared to the BRRD[15], the Proposal does not provide for the payment of the difference to be made by resolution financing mechanisms. This leaves open the question of which entity or entities will pay this compensation. We do not believe this is a good road to take, especially if the national legislatures themselves do not define this point when incorporating the directive into their own laws. The absence of definition will weaken the position of the injured parties, who may no longer know from whom to claim payment of the compensation due to them. Even if this is not the case, it may open the way for the entities involved in the resolution to escape responsibility for the payment. ■

13 See Decree-.Law 114-A/2014 of 1 August.

14 See article 55 of the Proposal.

15 See article 75 of the BRRD.