

No stability without trust

The bail-in mechanism has only been applied once, with Banco Popular, which was acquired by Banco Santander for one euro. This is the most controversial decision ever taken by the authorities in the European financial market. There are hundreds of disputes of the most varied kind. From questioning whether Banco Popular was deemed unviable to claiming that the authorities were guilty of prevarication or alleging that Banco Santander was unjustly enriched. There are 86 lawsuits [pending](#) before the Court of Justice of the European Union. All these lawsuits deal with the resolution mechanism and its effects on shareholders and junior bondholders with total loss of the invested capital. What nobody imagined is that a court decision would extend the effects of the bail-in to other creditors, in particular those entitled to compensation for having subscribed to Banco Popular shares with a misleading prospectus.

The [judgment](#) of the Court of Justice of the European Union of 5 May 2022 does not deal with shareholders affected by the resolution with total loss of the capital invested. It answers a question referred for a preliminary ruling on a quite different issue: do the effects of the bail-in extend to the right of creditors to be compensated for having subscribed for shares with a misleading prospectus? Directive 2014/59 governing the bail-in is silent on this point. The judgment makes a filigree move by transposing the Prospectus Directive 2003/71, which covers liability for misleading prospectuses, into company law in order to apply a recital of Directive 2014/59 extensively. This allows derogations from the shareholder protection rules of company law to be applied when they hinder the effectiveness of the bail-in, whereas the Prospectus Directive is in fact part of securities market law. In this respect, its transposition took place in Spain by means of a [reform](#) of the Securities Market Law.

The Court looks for a provision in the bail-in directive that justifies the sacrifice of creditors to compensation for having subscribed to shares with a misleading prospectus in the event

of resolution and does not find one. To justify that sacrifice, it cites Article 53(3) of Directive 2014/59, a provision which releases the bank which has been placed under resolution, or its successor, from the claims of shareholders who have been affected by the measure. However, this provision does not apply to those claiming liability for a misleading prospectus. These claimants act as defrauded investors, not as shareholders. If the resolution wants to extend its effects to all creditors, except of course depositors up to 100,000 euros who are guaranteed, it can do so. But in the case of the Banco Popular bail-in, the resolution only extended to shareholders and certain junior bondholders. It did not affect other creditors. Extending the effects of the resolution to creditors for compensation for a misleading prospectus is an extensive interpretation vetoed in the rules restricting rights. In this way, the judgment deprives misleading prospectus creditors of effective judicial protection without justification.

The financial system is a set of interlinked principles and rules. It guarantees the proper functioning of the market with investor protection as a guarantee of the stability of the system. It is a system based on trust. Contrasting investor protection with stability is absurd. Without investor protection, confidence in the system is damaged and the stability of the system is undermined. It is therefore striking that the Court of Justice of the European Union should contrast these principles in order to justify the suppression of the right to compensation for investors who had subscribed to shares with a misleading prospectus. The judgment states that "while there is a clear general interest in ensuring strong and consistent investor protection throughout the Union, that interest cannot in any event be regarded as prevailing over the general interest in ensuring the stability of the financial system". It thus contrasts investor protection with the stability of the system. The truth is that without confidence there can be no stability.

The judgement also states that this measure aims to "reduce moral hazard in the financial sector". However, leaving without effect the fraud of those who appeal for savings with a misleading prospectus does not contribute to reducing moral risk, on the contrary, it encourages such conduct, which would be validated with the subsequent bail-in.

The truth is that the bail-in system has not really taken off. After the bad experience of Banco Popular it has not been applied again. The Frankfurt technicians want to encourage auctions of bail-in banks. In the Popular case, Banco Santander was the only bidder. The Court is being led by these voices, shielding banks that acquire resolved banks from

lawsuits for having acquired shares with a false prospectus. This is a bad doctrine. It undermines confidence in the market by validating fraud and makes it difficult for banks to finance themselves. Who is going to buy shares in a bank knowing that in case of fraud by misleading prospectus, if the bank is under the resolution regime, the right to be compensated is lost?

There are other ways to encourage bidding at auctions of unviable banks. The bidder can make its offer conditional on an asset protection scheme (EPA, in Spanish Law), as has been [common](#) in the resolution of savings banks by the FROB. In the Popular case, Banco Santander decided to act uncovered without any protection, assuming full responsibility as universal successor: "[Without public aid](#)". In fact, it [made provisions](#) of millions of euros to face the lawsuits for misleading prospectus in the Banco Popular's capital increase. Not even the most optimistic of Banco Santander's lawyers would have dreamed that the European Court would release them from this legal risk with a ruling that deprives investors of their right to be compensated for misleading prospectus. Banco Santander is undoubtedly the main beneficiary of the ruling. It shields itself against lawsuits for public offerings with misleading prospectuses. But it maintains its responsibility as [underwriter](#) of Banco Popular's capital increase.