

Allen & Overy LLP

MEMORANDUM

To Eva Simon Thomas

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Subject **The level of inconsistency between the provisions of the CRD III and the principle of retroactive effect.**

1. INTRODUCTION

- 1.1 The Netherlands Bankers' Association (NVB) must before 8 November 2010 submit its comments on the CEBS High-Level Principles for Remuneration Policies. The recently adopted Capital Requirements Directive (CRD III) obliges the CEBS to formulate these principles. The CRD III also provides, put briefly, that the provisions on remuneration that are to be introduced in 2011 must also apply to remuneration over 2010, if paid in 2011.
- 1.2 This memorandum deals with the question whether (i) the CRD III introduces a provision with retroactive effect, and if so, (ii) whether there are any justification grounds for this, and whether (iii) in the event of inconsistency with the principle of retroactive effect, the provisions concerned in the CRD III do not have to be implemented into Dutch legislation.

2. ANALYSIS OF THE RELEVANT ARTICLES IN CRD III

- 2.1 The provisions (on remuneration) with respect to bonuses with credit institutions, like banks and investment firms, are contained in the CRD III (the Directive amending the Recast Banking Directive (2006/48/EC) and the Recast Capital Adequacy Directive (2006/49/EC)). The CRD III is to take effect as of 1 January 2011 and must be implemented into national legislation. Although the CRD III only takes effect on 1 January 2011, it also contains provisions that apply to some extent to the year 2010.
- 2.2 Consideration 22 of the Directive states as follows:
In order to guarantee their full effectiveness and in order to avoid any discriminatory effect in its application, the provisions on remuneration laid down in point 1 of Annex I to this Directive should be applied to remuneration due on the basis of contracts concluded before the effective date of implementation in each Member State and awarded or paid after that date. Moreover, in order to safeguard the objectives pursued by this Directive, especially the effective risk management, in respect of periods still characterised by a high degree of financial instability, and in order to avoid any risk of circumvention of the provisions on remuneration laid down in point 1 of Annex I to this Directive during the period prior to their implementation, it is necessary to apply such provisions to

remuneration awarded, but not yet paid, before the date of effective implementation in each Member State, for services provided in 2010."

- 2.3 Then, Article 3 CRD III states, among other things, as follows:
"The laws, regulations and administrative provisions necessary to comply with point 1 of Annex I shall require credit institutions to apply the principles therein to (i) remuneration due on basis of contracts concluded before the effective date of implementation in each Member State and awarded or paid after that date and to (ii) remuneration awarded, but not yet paid, before the date of effective implementation in each Member State, for services provided in 2010."
- 2.4 The provisions on remuneration in the CRD III thus pertain to:
- (i) remuneration due under contracts concluded before the coming into effect of the Directive awarded before, but paid after the coming into effect of the Directive;
 - (ii) remuneration due under contracts concluded before the coming into effect of the Directive awarded and paid after the coming into effect of the Directive;
 - (iii) remuneration due under contracts concluded after the coming into effect of the Directive, also awarded and paid after the coming into effect of the Directive;
 - (iv) remuneration awarded for services rendered in 2010 not yet paid before the implementation and/or coming into effect of the Directive in each Member State.
- 2.5 The CRD III partly contains provisions with retroactive effect, as they pertain to remuneration already acquired before the coming into effect of the CRD III. The Directive also covers bonus entitlements acquired in 2010 and paid in 2011, while the CRD III is to take effect only on 1 January 2011 and by then has to be partly implemented. This way, the European legislator may be acting contrary to European and Dutch legal principles.

3. THE PRINCIPLE OF RETROACTIVE EFFECT

(I) *Scope of the principle of retroactive effect*

- 3.1 Dutch law expresses the view that rules applied by a government as a basis for its actions, have to precede such actions.¹ This follows from the principle 'nullum crimen sine praevia lege criminali, nulla poena sine praevia lege poenali'²: "no crime and no punishment without preceding penal provision."³ Although this principle was codified in the Netherlands only in respect of penal law (section 16 Constitution and section 1 Penal Code) the principle also applies to administrative legislation, like the Financial Supervision Act (Wft), in which the CRD III is likely to become codified.⁴
- 3.2 Some professional literature has been arguing that the principle of retroactive effect is a general requirement of the rule of law that regulations, especially those onerous on its citizens, may not have retroactive effect.⁵ European case law, too, shows that regulations are not to take effect before being published. A regulation cannot be applied with retroactive effect if this would punish an individual⁶

¹ C.A.J.M. Kortmann, *Constitutioneel Recht*, Deventer, Tjeenk Willink, 2001, p. 318.

² See also De Poorter, *Tekst en commentaar Algemene Wet bestuursrecht*, artikel 5:4 Awb, annotation 2.

³ See also ECHR 9 February 1995, NJ 606, with ann. Kn (Welch); ECHR 22 November 1995, *Ars Aequi* 1996, p. 508, with ann. J. de Hullu (C.R. vs. V.K.).

⁴ See also De Poorter, *Tekst en commentaar Algemene Wet bestuursrecht*, artikel 5:4 Awb, annotation 2.

⁵ C.A.J.M. Kortmann, *Constitutioneel Recht*, Deventer, Tjeenk Willink, 2001, p. 318.

⁶ Case 63/83, *Kent Kirk*.

(read in this case: "prejudiced"), but retroactive effect is not prohibited if people benefit from it.⁷ This is an aspect of the principle of legal certainty.

- 3.3 The principle of retroactive force aims to ensure that legal situations governed by Community law are foreseeable (principle of legal certainty).⁸ This legal certainty is, in particular, a mandatory requirement with schemes that may have financial consequences.⁹ The principle of legal certainty, therefore, in general, opposes a Community resolution having retroactive effect, but also national laws, where these are aimed at the implementation of Community law.¹⁰

Level of inconsistency between the CRD III and the principle of retroactive effect

- 3.4 To determine whether the CRD III is inconsistent with the principle of retroactive effect, the moment the bonus entitlements were created has to be considered. We feel that the bonus entitlement *itself* is not created the moment parties agree on the bonus scheme concerned (like in an employment contract). Decisive for the creation of the bonus entitlement, in our view, is the moment the bonus becomes due. The bonus to which an employee under an agreed bonus scheme would be entitled, could be considered a claim on (a) condition(s) precedent. For only after the employee has performed as agreed (e.g. by realising certain targets), does he become entitled to a bonus. The realisation of the condition(s) (precedent), so whether or not he has performed or met certain targets in part or in whole, etc., makes the claim for bonus payment due and payable.¹¹ It is good to point out that in certain situations the conditions precedent can be satisfied without any further acts; this could be the case if the bonus scheme provides that bonus entitlements are created once certain targets have been met, or a party has performed as agreed. Suppose the scheme provides that in a certain financial year a certain result must be realised, then it can be argued that the bonus entitlement, if the result is realised within the financial year concerned, was already created at 23.59 p.m. on the last day of the financial year.

However, a bonus scheme may also contain a condition precedent which provides that the bonus entitlement is only created once a certain body of the legal entity/employer *has established* that certain targets have been met – e.g. the Supervisory Board, or the shareholders' meeting. In that case the bonus entitlement is created only after this has been established. In practice, this moment will always be in the next financial year.

- 3.5 As noted in 3.4, once the conditions precedent have been met, the right to a bonus payment becomes payable. However, the agreement or commitment that makes the bonus scheme applicable, creates justified expectations with respect to the entitlement thereto in the future. As such, a difference must be made between the various types of bonuses and bonus schemes.
- 3.6 First, there is the bonus that is determined simply by performance during the preceding financial year, promised on a nonrecurring basis, either before, during or after the financial year concerned. I would designate this the nonrecurring short-term bonus (hereinafter: **Nonrecurring STB**). Then, there is the bonus that still concerns one financial year only, but that has been included in the employment contract along established lines, and thus recurs annually. This category, like the Nonrecurring STB, is each year a short-term bonus. I would label this second category as the recurring short-term bonus (hereinafter: **Recurring STB**). A third category is comprised of the long-term bonuses, i.e. bonuses, the rights to which accrue over a period of more than one financial year. Often, they have three-year accrual periods. I would label this bonus scheme as the LTI bonus,

⁷ Case C-310/95, Road Air.

⁸ J.A. Kamminga, WFR 2005/360. De rechtszekerheid van de terugwerkende kracht van BTW-anticonstructiewetgeving.

⁹ See also Cases 98/78 (Racke), 99/78 (Decker), 114/81 (Isoglucose), C-143/93 (Van Es), case 326/85 (Netherlands/Commission), 84/78 (Angelo Tomadini), Netherlands/Council C-110-97, C-17/01 Walter Sudholz Finanzamt Sulingen.

¹⁰ J.A. Kamminga, WFR 2005/360. De rechtszekerheid van de terugwerkende kracht van BTW-anticonstructiewetgeving.

¹¹ See for an account of the exigibility of claims H. J. Snijders, E.B. Rank-Berenschot. Goederenrecht, Kluwer, Deventer, 2001, No. 430-431.

because in practice these types of bonuses, that accrue over more than one year, are called *Long Term Incentives*.

ENTITLEMENTS ALREADY AWARDED UNCONDITIONALLY

- 3.7 In any case, the CRD III is contrary to the principle of retroactive effect to the extent affecting entitlements already awarded unconditionally in 2010 with respect to either a Nonrecurring STB or an LTI bonus (as for the latter: an LTI bonus that has 31 December 2010 as the date when its accrual period expires). These are the remunerations described under category 2.4(i) of this memorandum.
- 3.8 To the extent a bonus entitlement is a Recurring STB, then as a minimum the entitlement *awarded* in 2010 is due and payable, with which the bonus entitlement as such was created in 2010.
- 3.9 In light of the fact that the bonus entitlements described in 3.7-3.8 were already created in 2010, the CRD III is inconsistent with the principle of retroactive effect, if the CRD III would aim to undo or impair these bonus entitlements. After all, a certain benefit obtained by a person (Bonus Entitlement) cannot be undone if at the time the benefit was acquired no statutory regulation (the CRD III) existed that would allow the undoing of such benefit.¹² This means that this, primarily, would mean impairing acquired rights without legal grounds, and only secondly inconsistency with the principle that measures may not affect individual rights by their retroactive effect.

ENTITLEMENT NOT YET UNCONDITIONAL

- 3.10 In principle, bonuses paid or finally awarded *after* 1 January 2011 on the basis of a Nonrecurring STB, a Recurring STB or a LTI scheme dating *before* 1 January 2011, become payable only after the date of the coming into effect of the CRD III. However, the (conditional) bonus commitment concerned was made at a time the CRD III had *not* yet come into effect. At the time, employer and employee were free to rely on having the rights and obligations towards each other under the bonus scheme concerned as agreed at such time – save in so far as the bonus scheme was agreed before the coming into effect of the CRD III with a view to circumventing the CRD III; on this, see 3.15 and 3.16 below.
- 3.11 With respect to commitments concerning the Nonrecurring STB, the Recurring STB and the LTI, it must be established whether (i) the commitment was such that the employee (and, in his tracks, the employer) could rely on it being satisfied, and (ii) the employer and employee did not agree on the bonus with a view to circumventing any announced regulations in the framework of the CRD III they had been aware of. This is discussed in more detail in section II.
- 3.12 When the conditions (i) and (ii) set out in 3.11 are met, a justification ground will have to exist for the application of the new CRD III regulations with retroactive force.
- 3.13 There are also bonus entitlements conceivable that were agreed on or promised before 1 January 2011 but that become payable only after 1 January 2011. Such bonus entitlements are not affected by the retroactive effect of the CRD III if they become *payable shortly after the date of implementation*, i.e. 1 January 2011, and if relating to a period which lies before 1 January 2010 (shortly after the date of implementation, in our view, meaning: within six or nine month after 1 January 2011). This will be the case, mainly, either with Nonrecurring STBs or with Recurring STBs, if the bonus entitlements were awarded conditionally over the year 2010. With respect to LTI bonuses that on 1 January 2011 have already accrued for one or two years, we feel that the LTI bonus accrual should stay intact *pro prata* for the period of accrual that has already elapsed. We are of the opinion that as of 2 January 2011 employees should simply take into account the fact that new rules have started to

¹² See also ECHR 9 February 1995, NJ 606, with ann. Kn (Welch); ECHR 22 November 1995, Ars Aequi 1996, p. 508, with ann. J. de Hullu (C.R. vs. V.K.).

apply, and that, for instance, Recurring STB schemes that are still in place will now fall under the new rules as of 2011. This should apply, in our view, also in light of what we considered in 3.4: the bonus entitlement is created only after the moment the bonus has become payable.

(II) *Justification ground for the principle of retroactive effect of the CRD III*

- 3.14 The question then arises whether this inconsistency with the principle of awarding of the CRD III can be justified.
- 3.15 As a general rule, retroactive effect upon civilians/companies of onerous rules is only allowable on grounds of substantial interests or special circumstances.¹³ The ECJ assumes such substantial interests to be present if there is a fear that financial structures may be created on a large scale between the moment the decision is taken to change the law and the moment this legislative change will take effect, so as to circumvent the legislation concerned (in this case the CRD III). Avoiding the creation of such structures may be a general interest that justifies Member States, by way of exception, to apply the technique of the retroactive effect of legislation.¹⁴ If no (justified fear of) circumvention (abuse of the law) exists, then the implementation of legislation with retroactive effect would be contrary to the principle of legal certainty and the principle of trust,¹⁵ i.e. the notion that citizens must be free to trust that certain rights that were created in the past will not be impaired.¹⁶
- 3.16 If there is a justified fear that structures are being set up to avoid the CRD III then the fact that the law is being abused could entail that the retroactive effect of the CRD III is justified.¹⁷ It is, in fact, this justification ground that is being invoked by the European legislator in the CRD III. After all, consideration 22 reads: "In order to guarantee their full effectiveness and in order to avoid any discriminatory effect in its application, the provisions on remuneration laid down in point 1 of Annex I to this Directive should be applied to remuneration due on the basis of contracts concluded before the effective date of implementation in each Member State and awarded or paid after that date. Moreover, in order to safeguard the objectives pursued by this Directive, especially the effective risk management, in respect of periods still characterised by a high degree of financial instability, and in order to avoid any risk of circumvention of the provisions on remuneration laid down in point 1 of Annex I to this Directive during the period prior to their implementation, it is necessary to apply such provisions to remuneration awarded, but not yet paid, before the date of effective implementation in each Member State, for services provided in 2010.
- 3.17 In light of the financial position of credit institutions, it seems unlikely to us that the law will be abused (that an attempt will be made to circumvent the CRD III). Credit institutions themselves also benefit from the formulation of firm provisions on remuneration. However, the European legislator has ruled – and the courts may concur – that a justification ground may exist to brush aside the principle of retroactive effect and to allow that this principle is acted contrary to.

(III) *Implementation of the CRD III into Dutch legislation and the principles of the regulator*

- 3.18 That the CRD III on minor issues is contrary to the principle of retroactive effect does not imply that the CRD III could not be implemented into Dutch legislation. A Directive is used to harmonize the legislation of the Member States, so to blend this legislation. In the implementation, the Member States are free to decide themselves on form and means.¹⁸

¹³ C.A.J.M. Kortmann, *Constitutioneel Recht*, Deventer, Tjeenk Willink, 2001, p. 318.

¹⁴ Case C-376/02 *Stichting "Goed Wonen"*.

¹⁵ Case C-7/02, *Holin Groep*.

¹⁶ J.A. Kamminga, *WFR* 2005/360. De rechtszekerheid van de terugwerkende kracht van BTW-anticonstructiewetgeving.

¹⁷ See also case C-487/01, *Municipality of Leusden*.

¹⁸ F. Amtenbrink; *Europees recht*, Den Haag, Boom Juridische uitgevers, 2007, p. 60.

3.19 Only the parts in the CRD III that (I) are contrary to the principle of retroactive effect, and (II) for which no justification grounds exists, should thus not be implemented. We feel that the same should apply with respect to the principles that are formulated by the regulators (DNB and CEBS).

4. CONCLUSION

4.1 It follows from the above that bonuses that have become payable before 1 January 2011 can be impaired lawfully by the retroactive effect of the CRD III. It also follows from the above that entitlements under bonus schemes that became payable shortly after 1 January 2011 and that relate to a period before 1 January 2010, in our view cannot be impaired lawfully by the retroactive effect of the CRD III.

4.2 The conclusion set down in 4.1 would only be different if it would be likely that bonus schemes or bonus commitments were created deliberately with a view to circumventing the CRD III – a circumvention which may already have been contemplated at the time of announcement of the provisions contained in the CRD III. That the CRD III on minor matters is contrary to the principle of retroactive effect does not imply that the CRD III could not be implemented into Dutch legislation. Only the parts in the CRD III that (I) are contrary to the principle of retroactive effect, and (II) for which no justification grounds exists, should thus not be implemented, and thus also not included in the generally worded principles of the regulator.

4.3 Finally, we note as follows. The provisions of the CRD III have a legitimate basis, namely the broadly supported view of society that bonus schemes have become too extravagant and should be cut down. As such, the CRD III fits in with other, comparable regulation in this area, like last year's Banking Code. Such regulations, however, cannot be so drastic that they brush aside existing entitlements or entitlements someone justifiably trusts to become final. Only recently, the Court of Appeal of Arnhem again indicated in clear terms that arrangements are to be honoured – *pacta sunt servanda* – and that this rule can only be deviated from in highly exceptional cases: the Court stated this view in connection with commitments made to bankers about exit arrangements and loyalty bonuses¹⁹. This judgment, too, underlines how high the bar has been set for giving retroactive effect to legislation or regulations that affect individual contracts.

¹⁹ Court of Appeal Amsterdam zp Arnhem 28 october2010, JAR 2010/270 en LJN BN8468);