Banking - Austria

Hypo Alpe-Adria-Bank International AG – bail-in on shaky foundations?

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Turmoil and special legislation

In 2007 Carinthia sold Hypo Alpe-Adria-Bank International AG (HAA) to BayernLB. In December 2009 Austria nationalised HAA for emergency reasons. Both the circumstances of the sale to BayernLB and the nationalisation are subject to court proceedings.

Since 2009 Austria has taken material efforts – including financial efforts – in order to determine the best way to proceed with HAA. Finally, after lengthy fact-finding missions and more than €3 billion paid into HAA, four new acts on the reorganisation of HAA came into force on August 1 2014. Pursuant to the Ministry of Finance, the "legislation is intended to ensure that the bank's assets are sold on best possible terms, and that previous shareholders and subordinated bond holders should bear a share of the restructuring costs".(1)

Material aspects of HAA legislation

In addition to certain amendments to the regulatory framework, the HAA legislation:

- establishes a winding-up company for its Italian subsidiary and Hypo South Eastern European Holding AG, which will be sold;
- establishes the legal framework for an asset management company without a banking licence which HAA will be transformed into; and
- allows for the bail-in of (subordinate) creditors (provided for in the Federal Law on Remedial Measures for HAA).

Although other parts of the HAA legislation provide for interesting particularities (eg, an *ex actu* licence for the asset management company, the partial applicability of the Banking Act to the asset management company and its partial exemption from basic principles of corporate and insolvency laws), the most interesting and heavily discussed parts are the Federal Law on Remedial Measures for HAA and the envisaged bail-in. According to the Ministry of Finance, the law:

> "*calls for spreading roughly EUR 1.69 billion of the costs of breaking up Hypo amongst subordinated bond holders and previous shareholders. Subordinated debt in the amount of EUR 890 million for which the province of Carinthia has provided deficiency guarantees shall be bailed-in as a contribution to the restructuring of the Bank. Only these liabilities and related deficiency guarantees by the province of Carinthia on those liabilities shall be cancelled… The scheme also envisages the inclusion of EUR 800 million in loans from Bayern LB, which were provided to Hypo Alpe Adria after the grant of state owned participation capital to Hypo Alpe Adria on 29 December 2008.*"(2)

Bail-in

The Federal Law on Remedial Measures for HAA provides the legal basis for reorganisation measures (allegedly) pursuant to Article 2 of EU Directive 2001/24/EC. The Financial Market Authority (FMA) is appointed as the administrative authority authorised to enact such measures.

On August 7 2014 the FMA issued the regulation required under the law, setting forth:

- the subordinated obligations (primarily those with a deficiency guarantee by Carinthia); and
- the liabilities towards (former) shareholders established during a specified period (subordinated obligations and liabilities towards former shareholders are together termed 'restructuring obligations'), which cease to exist.

Annexes 1 and 2 to the FMA regulation sets out a list of instruments that always qualify as restructuring obligations. In accordance with the law, guarantees and sureties given for the benefit of restructuring obligations cease to exist.

In addition, the law determines a statutory deferment of disputed restructuring obligations(3) (ie, obligations that are, as of June 1 2014, subject to court proceedings on their legal qualification as subordinated obligations or liabilities towards shareholders). Once a final decision on their qualification as restructuring obligations is reached, those disputed obligations will cease to exist.

The law also contains measures in favour of creditors of restructuring obligations. First, the law imposes a dividend distribution ban, effective until 2019. Second, if any liquidation proceeds remain after finalisation of the liquidation of HAA's assets, such proceeds will be distributed proportionally to creditors of the restructuring obligations. The respective claims will rank above claims for liquidation proceeds of the shareholders at that point.

The law also affects the rights of creditors not directly affected by the bail-in. If any measures under the law provide a creditor with statutory or contractual rights on termination, consent or any other right to alter a legal relationship (the explanatory notes expressly address material adverse change clauses or cross-default clauses) or to request security for its claims, they cannot be exercised as a matter of the law.

Shaky foundations?

The HAA legislation has been heavily criticised by rating agencies, market participants and banking associations. Even the International Money Fund has recently criticised the envisaged actions under the legislation. The government itself expects investors to attack the legislation. Based on the Ministry of Finance's statements, if push comes to shove, a potential settlement would depend on the given case and how litigation develops.

Pursuant to the Constitution, the president must countersign any legislation passed by Parliament. Following consultations with several legal experts, the president did not consider the law "openly" unconstitutional on its face, which would have prevented him from signing it. In a statement issued in connection with the signing, the president qualified the HAA legislation as an expropriation which, in accordance with the specific jurisdiction of the Constitutional Court, requires the existence of a public interest in order to be justified, and further stated that by signing the law, he intended to give the Constitutional Court the opportunity to review the legislation.

In addition, the World Bank (via a subsidiary) holds instruments that qualify as restructuring obligations and is therefore exposed to HAA. Based on international agreements and the bylaws of the World Bank, World Bank assets cannot be part of a haircut. Therefore, the envisaged bail-in might be ineffective against World Bank assets. The World Bank allegedly requested exemption from the bail-in. However, exempting the World Bank would result in an unequal treatment of creditors,(4) giving the other holders of restructuring obligations further ammunition to fight the HAA legislation. Minister of Finance Michael Spindelegger stated that he was unaware of the World Bank's exposure, calling it "a big surprise". He further stated that the situation must be resolved, possibly in court.

Directive 2001/24/EC

Directive 2001/24/EC intends to "preserve or restore the financial situation of a credit institution" by way of "reorganization measures",(5) which must be performed in accordance with local laws. The legislature makes extensive use of the term 'reduction of claims', while the legislation's explanatory notes provide no basis for such reduction of claims. Additionally, the reorganisation measures are used to reduce HAA's balance sheet before implementing the restructuring of HAA and therefore are not intended to "preserve or restore the financial situation" of HAA as a credit institution as required under Directive 2001/24/EC. Finally, this directive mainly addresses procedural issues, not questions of substantive law. The government has argued that this directive constitutes the legal basis for the bail-in; therefore it is unconvincing and possibly incorrect.

Directive 2014/59/EC

In response to the criticism, the government released press statements that also relied on this directive as justification for the envisaged bail-in. The bail-in tool is regulated under Article 43 of Directive 2014/59/EU. The authority may use the bail-in tool to reduce debt only if there is a reasonable prospect that the application of this tool with other reorganisation measures can restore the institution or entity to a financially sound state. It is inappropriate to apply the bail-in tool to claims that are secured, collateralised or otherwise guaranteed. However, in order to ensure that the bail-in tool is effective and achieves its objectives, it should be applied to as wide a range of the unsecured liabilities of a failing institution as possible.

Essentially, the directive requires the authority to apply the bail-in tool in a way that respects the equal treatment of creditors and the statutory ranking of claims under the applicable insolvency law. Losses should first be absorbed by regulatory capital instruments and should be allocated to shareholders through the cancellation, transfer or severe dilution of shares. Where those instruments are insufficient, subordinated debt should be converted or written down. Senior liabilities should be converted or written down if the subordinate classes have been converted or written down entirely. Since not all subordinated creditors are affected by the bail-in,(6) the requisite fair treatment is not ensured. In addition, the directive's principle that the bail-in must not put creditors at a disadvantage compared to an insolvency scenario is clearly violated. The guarantee by the state of Carinthia – given with respect to most of the subordinated notes – would take effect if insolvency proceedings were

opened.

Constitutional Law, CRF and European Convention on Human Rights

Austrian constitutional law, the Charter of Fundamental Rights of the European Union (CFR) and the European Convention on Human Rights all contain rules regarding the protection of private property. According to settled case law, an expropriation is legitimate only if it is:

- imposed by law;
- for the purpose of a public interest; and
- principally against remuneration.

The purpose of public interest is at least questionable in the given case. Whether the newly established claim for creditors of restructuring obligations regarding remaining liquidation proceeds can be qualified as remuneration is also questionable, in particular since it is unlikely that there will be any such proceeds.

In connection with the repeal of the guarantee by Carinthia, another issue could arise as constitutional law protects legitimate expectations (ie, buyers that relied on the guarantee by Carinthia).

Procedural questions

Based on the information available so far, HAA or Carinthia could be sued, subsequently moving for the competent court to file a request with the Constitutional Court to review the FMA's regulations. Additionally, investors might directly file a motion with the Constitutional Court through an individual application. Claims against Austria based on the European Convention on Human Rights are also possible.

In contrast to Austrian constitutional law, and based on the primacy of EU law, Austrian courts and authorities cannot apply national laws that break an EU law. In such case the Austrian court or authority would need to assess whether there is a conflict with EU law and, if in doubt, ask the European Court of Justice for clarification. With regard to the CFR, the Constitutional Court considers itself competent to review (and subsequently repeal) laws that potentially conflict with the CFR. Affected creditors might also derive claims from international investment treaties or other sources of international law in order to fight the HAA legislation – for example, a claim might be derived from the World Bank.

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Endnotes

(1) www.english.bmf.gv.at/carousel/law-hypo-alpe-adria.html (status as of September 5 2014).

(2) www.english.bmf.gv.at/carousel/law-hypo-alpe-adria.html (status as of September 5 2014).

(3) Such obligations are specifically marked with "*strittig*" in Annex 1 of the HAA legislation.

(4) An unequal treatment of two identical or comparable situations might conflict with European Union and Austrian constitutional law.

(5) That is:

> "*measures which are intended to preserve or restore the financial situation of the credit institution and which could affect third parties pre-existing rights, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims*" (Article 2 of Directive 2014/59/EC).

(6) For example, subordinated creditors enjoying a guarantee by Austria are not affected.