Feature

**KEY POINTS**

- BayernLB and Austria are locked in a battle over the winding-down of Hypo-Alpe-Adria Bank, with BayernLB one of the largest creditors "bailed in" under a new special law which cancels sub-sovereign guarantees.
- A complaint by BayernLB to the Austrian Constitutional Court may lead to a reference to the CJEU over interpretation of the Bank Recovery and Resolution Directive.
- There are strong arguments that the new law fails to adhere to key restrictions on use of the bail-in tool. Interpretation of Arts 43 and 44 of the Bank Recovery and Resolution Directive is likely to be crucial to determining the legality of cancelling sub-sovereign guarantees as part of a bail-in.

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# Putting the Bank Recovery and Resolution Directive to the test

This article examines a dispute over one of the most controversial European bank bail-ins to date, of Hypo-Alpe-Adria Bank, and considers how the CJEU is likely to interpret the bail-in powers in the Bank Recovery and Resolution Directive.

The likelihood of the Court of Justice of the European Union (CJEU) being required to rule on EU bail-in legislation has significantly increased, as German Landesbank BayernLB pursues a complaint to the Austrian Constitutional Court over alleged "expropriation" of €800m in guaranteed loans as part of the bail-in of failed Austrian lender Hypo-Alpe-Adria Bank International AG (HAA).

Austria's "Federal Law on Remedial Measures for HAA", which came into force on 1 August 2014, seeks to wind down the troubled bank whilst avoiding much of the burden falling on Austrian taxpayers. It breaks new ground by wiping out €800m of loans by BayernLB (which is 94% owned by the state of Bavaria) and €890m of other subordinated debt, despite guarantees by HAA's home province of Carinthia. (It is likely that the ultimate bill under the guarantees would have been picked up by the central Austrian government.)

The Federal Law raises significant questions about the scope and interpretation of the Credit Institutions Reorganisation and Winding Up Directive (2001/24/EC) ("CRWD") and the Bank Recovery and Resolution Directive (2014/59/EC) ("BRRD"). Many of these issues are unlikely to be found "*acte clair*" and therefore, unless Austria reaches a settlement with BayernLB and other affected creditors, may necessitate a reference to the CJEU, which would provide welcome insight on the limits of the bail-in powers.

## FEDERAL LAW ON REMEDIAL MEASURES FOR HAA

HAA has had a troubled history since a decade of breakneck expansion in Austria and the Balkans came to a sharp halt in the financial crisis. It was sold by the province of Carinthia to BayernLB in 2007, bailed out by the Austrian government in 2008, and then nationalised in 2009.

The Federal Law is part of a package of measures seeking to avoid HAA simply going into insolvency by instead transforming it into an asset management company (Heta Asset Resolution AG) without a banking licence and partially exempt from normal insolvency laws, in order then to wind down its portfolio and realise its assets. This will be carried out via a federal divestment holding company.

The Federal Law provides for:

- bail-in of €890m of subordinated debt with redemption dates pre-dating 30 June 2019, for which Carinthia had provided deficiency guarantees, together with cancellation of those guarantees (however, guarantees by the State of Austria in respect of debt with redemption dates post-dating 30 June 2019 will not be cancelled);
- bail-in of €800m of loans from BayernLB made after the 2008 bail-out, which were also guaranteed by Carinthia;
- compulsory deferral of disputed restructuring obligations until 2019; court proceedings will determine whether they qualify as restructuring obligations, in which case they will cease to exist;
- any liquidation profits to be distributed proportionately to creditors of restructuring obligations and then to shareholders, but without any regard to the guarantees.

Likely to give rise to further controversy is the fact that the guaranteed subordinated debt includes €150m of debt held by a subsidiary of the World Bank, the International Bank for Reconstruction and Development. The World Bank has sought an exemption from the bail-in. Ordinarily, international convention is that it is given preferred creditor status. However, to date Austria has refused, and the World Bank is said to be considering legal action (Art VII(4) of the IBRD's Articles of Association provides that its assets are "immune from… expropriation or any other form of seizure by executive or legislative action"). If the World Bank were exempted, the burden would fall yet more heavily on other bondholders, which might well give rise to further arguments that the bail-in offends the principle of equal treatment between creditors.

This is only one strand of a long-running dispute between BayernLB and Bavaria, on one side, and HAA and the Austrian authorities, on the other. The Munich Regional Court has begun hearing the trial of BayernLB's action against HAA for refusing to repay €2.4bn of loans following HAA's nationalisation in 2009. HAA claims it was under-capitalised from 2007-2009 and that BayernLB's managers hid

this from regulators and investors; it has counterclaimed for repayment of €3.4bn of loans that have already been redeemed. Separately, in December 2014 Austria filed a claim against BayernLB for €3.5bn alleging it was misled about HAA's financial condition when Austria agreed to bail it out in 2008. In the same month BayernLB sued Austria for €2.4bn claiming the government had guaranteed HAA's post-nationalisation loans. On 12 December 2014 the Vienna Commercial Court handed down judgment dismissing a test case brought by BayernLB against one of the former shareholders from which it bought HAA, finding that BayernLB had been misled but would have bought the bank without a discount anyway; BayernLB has said it will appeal.

Meanwhile, Austria has agreed to sell off HAA's prime asset, its Balkans network, to US private equity firm Advent International and the European Bank for Reconstruction and Development. A sale was one of the European Commission's conditions for permitting Austria to grant state aid to HAA. BayernLB has indicated it will refuse to consent to the sale, which if it led to the deal falling through could put HAA in breach of the EC's state aid conditions.

## NEW TERRITORY FOR EUROPEAN BAIL-INS

Bailing in instead of bailing out is the new normal in the Eurozone. No wholesale legal challenge to a bail-in has yet been successful, but none has gone as far as the HAA bail-in in cancelling deficiency guarantees by a sub-sovereign body.

### Cyprus

In the case of Cyprus in 2013, depositors with uninsured deposits over €100,000 were bailed-in as shareholders to recapitalise the Bank of Cyprus and the Laiki Bank, whereas insured deposits were exempt. A number of actions for damages have been brought by investors in the CJEU, but none have yet been determined by the court. For example, in *K Chrysostomides & Co v Council* (Case T-680/13) the applicant is bringing claims on the following bases:

- Extra-contractual liability of the EU for losses resulting from adoption of the bail-in scheme (pursuant to Arts 268, 340(2) and 340(3) TFEU).
- Violation of the right to property in Art 17(1) of the Charter of Fundamental Rights of the EU ("the Charter") and Art 1, Protocol 1 of the European Convention on Human Rights (ECHR).
- Breach of the principles of proportionality, protection of legitimate expectations, and non-discrimination.

### Netherlands

In 2013, the Netherlands nationalised SNS Bank and SNS Reaal, expropriating the holdings of shareholders and junior bondholders without compensation. The Amsterdam Court of Appeal's Enterprise Chamber ruled that compensation should be paid, but this did not derail the bail-in as a whole. The European Commission adopted Decision C (2013) 1053 (22 February 2013), finding that state aid provided by the Netherlands as part of the bail-in was compatible with the internal market. A challenge to this decision, *Adorisio v Commission* (Case T-321/13) was ruled inadmissible by the CJEU, including on the basis that annulment of the Commission's Decision would not have any legal effect on the expropriation of the applicants and it had not been shown that, even if annulment led to the insolvency of SNS Bank and SNS Reaal, this would procure any advantage for them.

### Spain

The Spanish bail-in legislation introduced under Royal Decree-Law 24/2012 (in force from 31 August 2012) mirrors Spanish insolvency law, with shareholders the first to bear losses, followed by preference shareholders and then bondholders in order of priority. There is specific provision that investors whose assets are expropriated are entitled to payment of no less than that which they would have received in an insolvency situation. This may be at least in part why there has been no reported wholesale challenge to the Spanish bail-in mechanism in either the CJEU or the Spanish administrative courts.

## CREDIT INSTITUTIONS REORGANISATION AND WINDING UP DIRECTIVE

CRWD does not seek to harmonise reorganisation and winding up measures across Member States, but principally aims to ensure that such measures are mutually recognised (see recital (6)). "Reorganisation measures" are defined in Art 2 as:

> "measures which are intended to preserve or restore the financial situation of a 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 3 provides that member states "shall alone be empowered to decide on the implementation of one or more reorganisation measures in a credit institution", in accordance with domestic law. The Directive envisages that credit institutions in difficulty must be wound up in the absence of reorganisation measures or in the event of such measures failing (recital (13)).

However, the Directive does not specify the content of powers to implement reorganisation measures. Nor does it mandate any derogation from fundamental Treaty principles, such as the principle of equal treatment between creditors (to which express reference is made in recitals (12) and (16)). Accordingly, it would be questionable if it were suggested that CRWD provides a mandate for the Federal Law, which both disadvantages creditors as compared with an insolvency situation, and treats creditors unequally since guarantees by Austria will be honoured whilst guarantees by Carinthia are cancelled.

Austria does not itself appear to rely on CRWD for that purpose. According to an Opinion of the European Central Bank dated 29 July 2014 on a draft version of the Federal Law:

"Article 6 of the draft law states that the Federal Law on the reorganisation of [HAA] serves the purpose of transposing Directive 2001/24/EC. The ECB understands that the sole purpose of this provision is to establish that measures provided for in the draft law are reorganisation measures within the meaning of Article 2 of that Directive."

However, even that limited reliance may be misplaced. The measures under the Federal Law arguably do not fall within the definition of "reorganisation measures" at all, since there is no intention for HAA to continue in existence as a credit institution; it is therefore doubtful whether these are measures "intended to preserve or restore the financial situation of a credit institution". In particular, HAA will no longer have a banking licence; rather, the intention is to restructure HAA prior to winding down in order to avoid the burden that would fall on Austrian taxpayers in a straightforward insolvency situation.

## BANK RECOVERY AND RESOLUTION DIRECTIVE

The Austrian Government also relies prospectively on BRRD, which entered into force on 2 July 2014 and is to be implemented across Europe by 1 January 2016. BRRD is a minimum harmonising measure intended to establish "a framework for the recovery and resolution of credit institutions and investment firms"; member states are allowed to adopt or maintain stricter or additional rules (Art 1(2)).

### Bail-in tool

BRRD Arts 43 and 44 establish the objective and scope of the bail-in tool. Member states are required to ensure that national resolution authorities have all of the resolution powers specified in Art 63, which include the power to cancel debt instruments. Use of the bail-in tool is subject to the conditions in Art 43(2), namely that it must be exercised:

(1) having regard to the resolution objectives in Art 31, including avoidance of significant adverse effects on the financial system, and protection of public funds "by minimising reliance on extraordinary public financial support";
(2) in accordance with the general principles governing resolution in Art 34, which include that creditors shall bear losses in accordance with the order of priority of their claims under normal insolvency law, creditors of the same class are to be treated equally, and no creditor shall incur greater losses than would have been suffered in an insolvency situation; and
(3) for at least one of the following purposes:
(a) to recapitalise an institution so that it can continue its authorised activities, such as banking activities (but only if there is a "reasonable prospect" of measures restoring the institution to "financial soundness and long-term viability"); or
(b) to convert to equity or reduce the principal amount of claims or debt instruments that are transferred pursuant to one or more of the other resolution tools provided in BRRD, namely:
   (i) to a bridge institution (ie a company controlled by the resolution authority which temporarily takes ownership of the institution: Art 40), or
   (ii) under the "sale of business tool" (ie sale on commercial terms to a purchaser who will continue the relevant authorised activity, such as banking: Art 38) or the "asset separation tool" (ie transferring assets to an asset management vehicle controlled by the resolution authority with the aim of selling or winding them down: Art 42).

Given that the intention is not for HAA to continue its authorised activities, Austria could only rely on the purpose of converting to equity or reducing debt prior to use of the bridge institution and asset separation tools.

### Restrictions on use of bail-in tool

There are significant restrictions on use of the bail-in tool, which are likely to be relied on by BayernLB and other investors to question the legality of the HAA Federal Law.

Firstly, Art 44 BRRD provides that the bail-in power is not to be applied to certain types of liability, including covered deposits and secured liabilities such as covered bonds and secured hedging products. "Covered deposits" refers to deposits protected under a deposit guarantee scheme (see Art 2(1)(5) of Directive 2014/49/EU on deposit guarantee schemes). However, recital (70) appears to go further and states that: "[i]t is not appropriate to apply the bail-in tool to claims in so far as they are secured, collateralised *or otherwise guaranteed*." The words "or otherwise guaranteed" are not found within the articles of the Directive itself, but appear to suggest that EU lawmakers did not envisage BRRD being used as the basis for cancellation of guarantees (not just in respect of covered deposits under a deposit guarantee scheme).

Secondly, any resolution action is expressly subject to the provisions of the Charter. As stated in recital (13), "[i]n particular, where creditors within the same class are treated differently in the context of resolution action, such distinctions should be justified in the public interest and proportionate to the risks being addressed and should be neither directly nor indirectly discriminatory on the grounds of nationality."

Thirdly, the resolution tools such as the bail-in tool should only be applied where they are necessary and the institution cannot be wound up under normal insolvency proceedings without destabilising the financial system; the principle of proportionality should be taken into account (recital (49)). Interference with property rights should not be disproportionate, and affected shareholders and creditors should not be worse off than under normal insolvency proceedings (recitals (50) and (73)). The bail-in tool should be applied so as to respect the *pari passu* treatment of creditors

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and the statutory ranking of claims under the applicable insolvency law (recital (77)).

Although as stated in recital (55) the resolution tools should be applied before resort to extraordinary public financial support, the Directive expressly envisages circumstances in which public financial support may be provided (subject to state aid rules) to protect deposits covered by deposit guarantee schemes or discretionarily excluded creditors.

resolution of HAA.

Accordingly, it may well be possible for BayernLB and others to argue successfully that cancellation of the Carinthia guarantees is a disproportionate interference with property rights and a breach of the Charter and ECHR. The Federal Law does not provide for reasonable compensation, as is usually a requirement in cases of expropriation (and as the Dutch courts held in the case of SNS Bank and SNS Reaal).

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## BRRD as basis for HAA Federal Law

There are strong arguments that the Federal Law contravenes the restrictions on the use of the bail-in tool.

Firstly, recital (70) suggests the bail-in tool should not be applied to guaranteed claims, which appears to be wider than just "covered deposits" under a deposit guarantee scheme. However, given that the words "or otherwise guaranteed" are not repeated in the body of the Directive, it will be interesting to see whether the Constitutional Court (and, if necessary, the CJEU) interprets this as applying to the guarantees by Carinthia or construes it more narrowly as including only covered deposits.

Secondly, there is clear unequal treatment of subordinated creditors within the same class since guarantees by Carinthia, but not those by Austria, have been cancelled. It is difficult to see a coherent justification for this distinction, let alone how it is proportionate in light of the very substantial disadvantage suffered by holders of debt guaranteed by Carinthia. Although EU policy increasingly seeks to avoid taxpayers shouldering the burden of struggling financial institutions before bondholders (hence the policy shift from bail-outs to bail-ins), on the face of it any future demand on the guarantees provided by Carinthia would not have been "extraordinary public financial support" of the type deprecated by BRRD: the guarantees were provided to BayernLB and others on a commercial basis years before the

On the other hand, the CJEU tends to afford member states considerable discretion over how they organise their financial affairs, making the court slow to intervene. It would therefore be interesting to see whether the CJEU would draw the distinction between recourse to taxpayers based on pre-existing liabilities and recourse as a direct result of a bank resolution.

Thirdly, there may well be an argument that cancellation of the Carinthia but not the Austria guarantees is indirectly discriminatory on grounds of nationality if (as seems to be the case) the Carinthia guarantees were given disproportionately in favour of non-Austrian bondholders such as BayernLB in the wake of the 2008 bail-out of HAA.

Fourthly, the cancellation of the guarantees by Carinthia means creditors are significantly worse off than they would have been in a straightforward insolvency situation. Again, there is a lack of credible justification for departing from ordinary insolvency principles (which are generally respected as part of bail-in mechanisms, such as that of Spain in Royal Decree-Law 24/2012). The potential burden on taxpayers in a normal insolvency situation arises from pre-existing liabilities under the guarantees, rather than being akin to taxpayers being forced to bail out a bad bank, so the justification for avoiding that burden seems weak.

## NEXT STEPS

HAA will have until around January 2015 to respond to BayernLB's complaint to the Constitutional Court, and a ruling is expected later in 2015. Meanwhile, a number of other investors are taking action in the courts in Carinthia. Austria's Finance Minister has indicated willingness to hold talks with HAA's creditors. It is as yet unclear whether Austria will grant the World Bank preferred creditor status; if not, the World Bank could take action against Austria, but granting an exemption will reinforce BayernLB's complaints of unequal treatment.

It waits to be seen whether the Austrian courts consider they need to interpret and apply the Directives in order to determine the complaint, and if so whether they consider the EU law in this area to be "*acte clair*" or whether a reference to the CJEU is required. It will be particularly interesting to see what position Germany adopts on any reference, since on one hand it has spearheaded the EU's policy of bailing-in over bailing-out but, on the other, its own banking system has till now relied heavily on sub-sovereign guarantees to Landesbanken.

Whilst this continues, and BayernLB struggles in the German courts to recoup its loans made to HAA following its nationalisation in 2009, BayernLB may itself have to delay repaying loans received from Bavaria during the financial crisis, raising issues as to whether the European Commission would consider this a breach of state aid rules. ■

*Further reading*

- From bail-out to bail-in: Are banks becoming safe to fail? [2014] 8 JIBFL 494
- Valuation in resolution and the "no creditor worse off principle" [2014] 1 JIBFL 16
- Lexis PSL: Financial Services: Recovery and resolution: failing financial institutions