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Heta Asset Resolution

Does the Austrian Federal Banking Restructuring and Resolution Act (BaSaG), which implements the European Bank Recovery and Resolution Directive (BRRD), comply with the law seeing that it is applied to a wind-down company (in contrast to the EU Directive)?
Basically, the underlying EU Directive only sets minimum standards for harmonisation, which means that the Member States are free to implement stricter rules. The Austrian lawmakers have used this possibility when they adopted the BaSaG. The government's draft referred to this possibility and clearly states that Austria would use this leeway by applying the BaSaG to winddown companies as well. We will see whether BaSaG is compliant with the BRRD; in all probability, several parties will try to have it examined by the courts. The Austrian government currently assumes that the BaSaG is compatible with the BRRD. However, the final decision is reserved for the courts.

Under the BRRD, guaranteed bonds are exempt from loss sharing. Does the BaSaG include a similar clause, and might this apply in the current situation?
By way of publishing its Q&A's, the European Banking Authority (EBA) stated in early February that from its point of view guaranteed bonds may be included in a debt haircut. Under the BaSaG, secured claims are, in principle, exempt from loss sharing; according to the explanations to the BaSaG, the exemption covers collateralised claims which may, under Austrian insolvency law, be separated from the insolvency estate. This does not include claims which are collateralised or guaranteed by third parties. Our understanding is, that claims with a deficiency guarantee of the State of Carinthia in case of Heta therefore will not be excluded. However, also in this respect it has to be stated that the courts will ultimately decide on the interpretation.

The deficiency guarantee of Heta's senior bonds Are the deficiency guarantee of the State of Carinthia and the State Holding Law of Carinthia (Kärntner Landesholding Gesetz) compliant with each other? Will the deficiency guarantee apply only in case of insolvency?
According to the issuing prospectuses, a deficiency guarantee from the State of Carinthia exists. According to the deficiency guarantee in Sec 5 of the State Holding Law of Carinthia, the State of Carinthia assumed the liability in case Hypo Alpe Adria or its legal successor Heta becomes illiquid. Therefore the wording of the statutory provision of Sec 5 of the State Holding Law of Carinthia does only target the case of illiquidity. The question whether the deficiency guarantee also applies in case of over-indebtedness, i.e. Heta's situation, has to be answered negatively, irrespective of the fact that Heta is actually not insolvent as due to the moratorium, the claims are not due, and hence the situation of illiquidity is not present. Creditors cannot benefit from a deficiency guarantee until they can prove that the debtor has defaulted. And that is not the case, as the claims are not due under the moratorium. Moreover, Heta is not suffering a liquidity shortage either; as the Austrian Financial Market Authority (FMA) stated in its administrative ruling (Mandatsbescheid) that Heta currently has sufficient liquidity at its disposal. The situation might change once the moratorium expires, because at that time the question of an illiquidity
situation will definitely arise.

Is it possible that the deficiency guarantee itself does not comply with current legal provisions, as officials of the State of Carinthia have claimed?

Separate from the politically motivated comments, there have been doubts about the compliance of the deficiency guarantee because they could eventually violate EU law.. This has the following historical background: Through the assumption of liabilities for bonds issued by Hypo Alpe Adria, the Province of Carinthia facilitated the bank in pursuing its policy of expansion. Until April 2004, Hypo Alpe Adria had the possibility of indefinitely accumulating further debts and obligations on account of provincial regulations, which automatically, i.e. by law, fell within the liability of the State of Carinthia. The EU Commission considered this provincial assumption of liability as, an inappropriate distortion of competition. The Commission viewed it as state aid incompatible with the common market. In 2003, the Republic of Austria and the EU Commission agreed on the abolishment of this provincial assumptions of liability; however under a transitional arrangement which provided that until 2007, indefinite liabilities could be assumed by the State of Carinthia (limited to those liabilities, which would become due, on 30 September 2017 at the latest). This arrangement was – contrary to the actual purpose of the transitional period, based on which the provincial assumption of liability was, according to the overall tenor of the Commission, meant to be reduced - disproportionately exploited by Hypo Alpe Adria and the State of Carinthia, whereby deficiency guarantees increased from 2003 until the end of 2006 by approx. 1 ½ times. This could be a prohibited aid. The deficiency guarantee may hence be regarded as illegal state aid, independent of the moratorium.

How would you apply the "no creditor worse off" principle in the case of Heta, which says that a creditor must not be worse off under a wind-down than under an insolvency scenario? Would not the creditors receive the full amount of their claims in an insolvency, as the deficiency guarantee of the State of Carinthia would apply?

A guarantor is only liable for the existing primary debt. The State of Carinthia has not given a direct guarantee, but the deficiency guarantee as described. A deficiency guarantee is an accessory instrument (i.e. it depends on the amount of primary debt). A haircut, which would reduce the primary debt, would also reduce the amount of the deficiency guarantee according to the principle of accessoriness. If, for example, the initial debt amounts to 100 and is reduced by 70 due to a haircut, the deficiency guarantee will also be reduced by 70 and cover the remaining 30 only. To some extent, this collides with the case of insolvency, as in case of an insolvency scenario, in accordance with legal provisions creditors can claim the whole amount from the deficiency guarantor despite the removal of the primary claim. At the moment there is an area of tension between general civil law provisions and special provisions for wind-downs. It can be argued that the „no creditor worse off" principle is only applicable to the relationship with the primary debtor. As a consequence it has to be compared, how much the creditor would receive in case of a haircut on the bonds and how much he would receive as insolvency proceed in case of an insolvency (as long as the insolvency proceeds are not higher, this principle is not violated). We doubt that the "no creditor worse off" principle would prevail over the accessoriness principle; although this is arguable, it can rather be argued in our view that a haircut on the bonds can be considered as an insolvency scenario. It has to be considered that due to the moratorium at the moment, creditors are not yet worse off, as a haircut on bonds has not taken place. After the expiration of the moratorium, it will have to be ascertained whether creditors would have been better off in case of an insolvency than in the haircut scenario. It is not clear whether the "no creditor worse off" principle will be extended to deficiency guarantees of third parties, however this question has to be examined if this situation occurs. Ultimately, as the "no creditor worse off" principle applies ex post; the comparison will have to be made only after the completion of the winding up proceedings. Moreover, a voluntary debt haircut harbours the risk that the amount covered by the deficiency guarantee is reduced by the amount of the haircut.

The Financial Market Authority's moratorium Is it possible to object or even file a lawsuit against the moratorium? Are the FMA's actions legal? And would it be possible to extend the moratorium for an unlimited period of time?

The moratorium was ordered by the FMA by issuing an administrative ruling (Mandatsbescheid) using the leeway provided in the BaSaG. It is not possible to file a lawsuit against the moratorium, as it was implemented by administrative decision. However, investors have the possibility to file an objection (Vorstellung) against the moratorium to challenge the ruling under an administrative procedure. The FMA's ruling states that any objections must be filed within three months. We recommend this step to bondholders, as the moratorium suspends the possibility to make claims under civil law. In other words: it is necessary to object to the moratorium first in order to be able to make civil-law claims later on. In principle, it is possible to extend the moratorium due to the fact that the BaSaG does not state a time limit. Thus, it is quite possible and the Carinthian regional politics have already addressed the possibility of an extension of the moratorium. At the moment, the FMA believes, the 15 months deferral period caused by the moratorium would be sufficient and adequate. This suggests that any possible extension of the moratorium would certainly be only for another limited period of time, whereas the FMA in such case will need to explain, why the review takes longer than the initially foreseen period and why an extension is justified. Regarding the 15 month period the FMA has stated that an insolvency procedure would not be faster, however this line of argumentation will not hold in the long-term if the moratorium is extended.

Is the FMA's ruling equivalent to the opening of insolvency proceedings, so that the deficiency guarantee could come into effect?
It is doubtful whether an Austrian court would follow this argument. Before striving for a court decision payment needs to be requested from the State of Carinthia. However, Carinthia would object to doing so, as the claim is not due according to the moratorium. Therefore it is not possible to assert the claim against the primary debtor, whereas it is a requirement for successfully claiming on basis of the deficiency guarantee that the claim against the primary debtor has failed. If creditors would file a civil lawsuit the courts would most probably reject such suits. And it would be quite right to do so in our view. A moratorium is formally and substantively not the same as an insolvency. The moratorium ensures that the claims do not fall due and that Heta is not incapable of paying its liabilities; it is neither illiquid nor insolvent. Thus, there is no solid legal basis for claiming against the deficiency guarantor.

Should creditors assume that the objections against the FMA's ruling or the moratorium are successful and thus make claims against Heta as a precaution? Is it necessary to file a civil lawsuit even if it is rejected in order to be able to prove that steps to collect on the guarantee have been taken and to secure potential claims?
Of course, the provisions for (deficiency) guarantee say that creditors must not delay legal steps, but must take steps to collect on the claim. Due to the aforementioned reasons we do not consider a civil lawsuit as expedient. Dispatching dunning letters to secure claims is inexpensive; we recommend taking such a step. Especially objections should be filed to challenge the moratorium.

Haircuts on senior bonds
What would a voluntary haircut look like, and what would be the consequences? Would Austria have any means to force investors to agree to a voluntary debt haircut?
A debt haircut will also reduce the guaranteed amount, which is obviously not satisfying for creditors. However, under a realistic perspective Carinthia probably does not have the sufficient amount at its disposal for completely fulfilling the deficiency guarantees it has entered into. Thus, the value of the deficiency guarantee is doubtful anyway.

How will the negotiations about a voluntary debt haircut go?
Different from German law, which contains the German Act on Bonds (Gesetz über Schuldverschreibungen), Austrian law does not contain collective provisions on bonds. An institutional legal mechanism for collective decision making of bondholders does therefore not exist in Austria. In practice it cannot be assumed that the FMA will enter into negotiations regarding a haircut with the bondholders. We expect this to happen on a political level, if the FMA does not simply order the haircut of the bonds.

Could one try to determine Heta's insolvency in court?
In principle, creditors could do so, after filing an insolvency application against Heta. However it has to be considered, that under the official moratorium the company is currently not suffering from a liquidity shortage and this could not cause insolvency. According to the FMA's ruling, Heta actually has a sufficient cash position at its disposal. In fact, at the time the moratorium ends it can be assessed whether Heta is illiquid or over indebted and therefore an insolvent. In practice the moratorium will likely end in a haircut or in insolvency proceedings ordered by the FMA.

What can investors do?
Could the HAASanG, which was applied to junior bond of Heta in summer, also be applied to Heta's senior bond?
The scope of the BaSaG is broader, and even if the HAASanG is not upheld by the courts, the haircut of BaSaG could take place. It is imaginable that this might be applied to senior bonds – however, the law might again be challenged regarding the infringement of constitutional and EU law because it is unclear whether it complies with the constitution and EU law.

What should investors do in the current situation, and what chances of success do you see? How long would any steps take approximately?
At the moment, from our point of view the only appropriate way is to challenge the moratorium by way of objection. A lawsuit against the deficiency guarantor is set to fail, as the claim is not due. It is difficult to assess whether objections against the moratorium would be successful, especially because such a deferment of the due date is permitted under the current law. It would be necessary to find good reasons to argue why the moratorium as such is not permissible. Additionally it could be the case that the 15 months' time limit of the moratorium expires before the administrative procedure is completed. From our point of view, law suits against the primary debtor or the deficiency guarantor are not expedient because the moratorium is opposing.

Does it make a difference that the Heta bonds under German law are subject to the jurisdiction of the courts in Frankfurt? Does it make any difference if the bonds were issued under German or Austrian law?
This is another issue. The terms and conditions of the bonds, which govern the legal relationship between Heta and the bondholders, do include a jurisdiction clause under which the bonds shall be subject to the jurisdiction of Frankfurt courts and German law. This only applies to claims against the primary debtor, but not to the jurisdiction and the applicable law regarding the State of Carinthia as deficiency guarantor. Such claims would have to be made in front of Austrian courts or authorities under Austrian law.

Carinthia and the Pfandbriefstelle

Is Carinthia really unable to pay? Could Carinthia obtain money under a loan from the Austrian central government to pay its liabilities? Would the Austrian central government's claims on Carinthia also be affected by a debt haircut, or would it be possible to oblige Carinthia not to sell assets anymore? Would it be possible to seize claims of other States under the Austrian fiscal adjustment system in Austria?

These possibilities have been publicly discussed, but in practice they require the unlikely case that all parties agree. The measures mentioned appear unrealistic. Carinthia certainly has some assets at its disposal, for example the €500m Kärntner Zukunftsfonds, from the sale of Heta. It is likely that his fund has to be used up, although the State of Carinthia always tried to avoid this. A sale of other assets of the State of Carinthia (e.g. hospitals) appears difficult and remains de facto an unrealistic scenario. We do not believe that it would be possible to seize claims of the State of Carinthia via the fiscal adjustment system, which consists between the Austrian central government and the states. This is even less likely for claims of other Austrian states (as we do not see a legal basis therefore). However, it is quite possible that some will try to seize claims of Carinthia.

How would an insolvency of Pfandbriefbank, or former Pfandbriefstelle, play out? And could there be knock on effects to the other members of the Pfandbriefstelle?

Generally speaking, Pfandbriefbank's creditors of Heta other than bondholders are in a much better position. This is due to the construction of the Pfandbriefbank. The eight Austrian provincial mortgage banks (Landes-Hypothekenbanken) take direct and joint liability for it. If Pfandbriefbank is unable to service any liabilities, the provincial mortgage banks need to account for it. For this to happen, it is not necessary that the Pfandbriefbank becomes insolvent and this is not a realistic scenario either, because the respective states will be held liable for their provincial mortgage banks. The seven states affected – excluding Vienna, which does not have a provincial mortgage bank – have meanwhile explicitly stated that they will fulfil their responsibilities regarding these liabilities. At the same time, it was emphasized that in case it is intended to have recourse to both the Austrian central government and the State of Carinthia. However, Pfandbriefbank's creditors will not be affected by such subsequent measures.

Are the covered bonds of Heta, i.e. the public-sector Pfandbriefe according to Austrian Pfandbrief law (e.g. ISIN CH0023309286) affected by the moratorium as well? Where is the difference to the bonds issues by Pfandbriefbank?

Heta's public sector covered bonds are not included in the FMA's administrative ruling (Mandatsbescheid), on which the moratorium is based. This is based on the fact that the bonds are secured and is in line with the provisions of the BRRD. Any payment on these liabilities is hence not subject to any deferral of payment. (See also our Covered bond telegram of 5 March) The issues of former Pfandbriefstelle are a different kettle of fish. Pfandbriefstelle (now Pfandbriefbank) has acted as a funding vehicle for its members, the eight Austrian provincial mortgage banks (Landes-Hypothekenbanken). In return, the latter granted Pfandbriefstelle senior unsecured claims. These are included in list of Heta liabilities affected by the moratorium and can also be included if a haircut takes place. Hence, Pfandbriefstelle will not receive any payments on these claims for the time being. As stated in the previous question, however, there is a public commitment of the remaining seven regional states that the Austrian provincial mortgage banks will stand in for the payments to assure the solvency of Pfandbriefstelle. Investors exposed to Pfandbriefstelle are therefore subject to a high level of safety.

At CMS, an integrated team of experts from the fields of banking and capital markets law and dispute resolution deal with the legal aspects regarding the Heta case.
We are happy to answer further questions on this topic.

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