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BAIL-INS AND HAIRCUTS: IS SLOVENIA NEXT IN LINE?

Following the most recent manifestation of the European debt crisis in Cyprus, speculation is rife that Slovenia will be the next victim of the prolonged economic recession, together with its thinly capitalised banks. The European policy shift towards bail-ins (requiring investors to share in the cost of any rescue package) presents substantial risks for investors in the event that Slovenia is forced to seek financial assistance from Brussels or to restructure its sovereign debt. The approval of the European Union's Recovery and Resolution Directive by Finance Ministers on 27 June has further emphasised this shift.

Slovenia is a relatively small Central European nation state with a GDP of US$49.5 billion and a population of 2.05 million. While Slovenia enjoyed an initial period of prosperity after splitting from the Republic of Yugoslavia in 1991, joining the European Union in 2004 and the Eurozone in 2007, the European debt crisis plunged its export-based economy into a deep recession in 2011. That recession continues and has left Slovenia's banks saddled with €6.8 billion of non-performing loans and an urgent need to recapitalise.

Matters appeared to be reaching a head in March 2013 when Slovenia's cost of borrowing surged following a change in government and events in Cyprus, and then again in May 2013 when Slovenia was downgraded by Moody's. However, the Slovenian government bought itself time by closing a US$3.5 billion bond issue to meet its immediate financial needs and filing a rescue plan with the European Commission in which it indicated an intention to sell off state-owned companies and raise taxes.

If Slovenia's rescue plans are unsuccessful, then the most recent indications of the likely response from Brussels and, therefore, of the likely consequences for investors can be found in the approach taken towards Cyprus at the state level and in the Netherlands towards SNS Reaal NV and SNS Bank NV (together "SNS") at the bank level.

As far as SNS is concerned, although its nationalisation did not flow from the Dutch state's own inability to raise finance in the markets, it is significant nonetheless because the Dutch Minister of Finance, Jeroen Dijsselbloem, who signed off on the Decree implementing the nationalisation, has also been president of the Eurogroup since 21 January 2013 and president of the Board of Governors of the European Stability Mechanism since 11 February 2013.

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In addition to taking SNS' equity, Mr Dijsselbloem's 1 February 2013 Decree[1] also expropriated certain of the subordinated debt securities and capital components. This was an unprecedented move in the context of previous European bank bail-outs, a novelty factor made even more painful for investors by the subsequent offer of nil compensation to the victims of the expropriation.[2] The Minister deliberately departed from his predecessors' approach to the bail-out of other Dutch banks in and around 2008, explaining in his letter to the Dutch Parliament of 1 February 2013 that the rationale for expropriating the junior debt and other securities was to maximise the contribution of private investors to the cost of the nationalisation, thereby reducing the burden on taxpayers by a corresponding amount. The expropriation of senior bondholders was also explored, although dropped in the case of SNS in light of the Minister's concerns about the consequences (a likely increase in the cost of funding for all Dutch banks and the chance that such funding could dry up altogether).[3]

Concerns such as these did not, however, prevent the imposition of equivalent provisions at the senior bondholder and depositor level as a condition of the €10 billion bail-out of Cyprus. On the contrary, on 25 March 2013, the Eurozone Finance Ministers (including Mr Dijsselbloem), the International Monetary Fund and the President of Cyprus reached an in-principle agreement which provided for the adoption of austerity measures, the introduction of a privatisation program and the recapitalisation of Cyprus' banks, save for the most troubled, Laiki Bank, which is to be closed and its equity, debt (junior and senior) and deposits in excess of €100,000 expropriated (subject only to a claim in the subsequent liquidation).[4] It is estimated that this bail-in will contribute in excess of €4 billion towards the rescue effort, thereby limiting the bail-out required to €10 billion.

While unprecedented, the approaches adopted towards SNS and Cyprus both accord with the bail-in provisions found within the Recovery and Resolution Directive. However, as these provisions are not due to take effect until 1 January 2018, their de facto application to subordinated creditors in the Netherlands in early 2013 was surprising, as was the statement made by the European Commission in its decision of 22 February 2013 that the minimisation of the state aid element of the rescue package was something approaching a pre-requisite for the temporary approval that was sought.

The expropriation of senior creditors and depositors in Cyprus was more surprising still, and while some commentators suggested that the severity of the terms of the Cypriot bail-in might be a politically motivated anomaly, Mr Dijsselbloem rejected that viewpoint, instead describing the package as a "blueprint" for future European bail-outs.

Investors at every level of Slovenian banks should therefore be alive to the possibility that their assets could be expropriated as a part of any rescue with minimal or zero compensation offered in return.

In a sovereign debt context, Slovenia has used part of the proceeds of its recent debt issuance to meet impending repayment obligations. In the event that Slovenia is unable to raise further funds on the market and/or agree bail-out terms with the EU, it is likely to have to restructure its sovereign debt obligations. If this occurs, then the terms of Slovenia's October 2012 U.S. dollar bond issuance[5] manifest a desire to eradicate the prospect of investor "hold-out" litigation, particularly before U.S. courts.

Holdout litigation typically arises when the majority of bondholders are prepared to consent to a debt restructuring (usually a bond exchange offer providing for a significant haircut, i.e. lower and/or deferred payments) but a minority of investors withhold consent with a view to securing full payment under the terms of the original debt instrument, or at least payment in excess of that offered by way of exchange. The most high-profile examples of recent holdout litigation are the numerous cases pending before the New York courts[6] in connection with bonds issued by the Argentine Republic. What has been particularly

1 Issued under the Dutch Financial Supervision Act 2012.
2 Proceedings challenging the legality of the Decree and the offer of nil compensation are ongoing before the Dutch Courts, in which Jones Day acts for certain bondholders.
3 See pages 9 and 10 of the Minister's letter to the Dutch Parliament of 1 February 2013.
4 Deposits under €100,000 are to be moved to the Bank of Cyprus, and existing deposits held at the Bank of Cyprus that exceed €100,000 have been frozen pending a decision as to the extent of the bail-in required in the context of its regulatory capital needs.
5 US$2.25 billion Notes issued by Slovenia in October 2012.
6 *See*, e.g., *NML Capital Limited et al v. The Republic of Argentina* 12-105(L), in which Jones Day acts for certain bondholders.

newsworthy in that litigation is the New York courts' decision to enjoin Argentina from meeting its payment obligations under the exchange bonds unless rateable payments are made to certain holdout investors who still hold the old bonds (which would see them paid out immediately and in full). The grant of that injunctive relief flows in part from the New York courts' interpretation of the *pari passu* clause found in the old bond documents as requiring Argentina's debt repayment obligations to be met on a pro rata, *pari passu* basis. If the injunction were (i) to be affirmed by the Second Circuit and (ii) honoured by Argentina, then this would result in the holdout creditors receiving full payment of all capital and interest at the same time as the exchange bondholders receive their next interest payment (which is obviously a much better deal than was on offer in the exchange).

Slovenia's recent foreign bonds are denominated in U.S. dollars, are subject to English law and provide that the English courts are to have exclusive jurisdiction to settle disputes. While certain provisions within the Argentinean and Slovenian bonds are very similarly worded (including their *pari passu* clauses), the New York courts' interpretation of them would not bind the English court. This is particularly the case in respect of *pari passu* clauses because the available guidance in respect of the likely English law approach[7] suggests a narrower construction, namely one which requires only that the obligations in question rank equally with all other unsecured debt as a matter of mandatory law. If the English court were to endorse such a narrow approach, then investors' prospects of obtaining a rateable payment injunction akin to that granted by the New York courts would be low and England's attraction as a venue would increase, at least from an issuer's perspective.

To this end, while Slovenia has waived its sovereign immunity from suit and enforcement ex-U.S., it has specifically reserved its immunity in the context of any actions filed in the U.S. This is a novel way of dealing with the risk of the type of aggressive U.S. holdout litigation which has dogged many sovereign restructurings in the past.

Finally, unlike the bonds issued by Argentina, Slovenia's bonds contain collective action clauses (which include cross-series modification provisions). These permit amendments to the terms of the bonds (and across series of bonds) provided that aggregate outstanding principal voting thresholds are met. Accordingly, unless holdout investors control sufficient voting interests to block any such action, they may face the prospect of being crammed down and a debt restructuring forced upon them by the majority.

In consequence, the risks and opportunities presented to investors in respect of any restructuring of Slovenia's sovereign debt may take a very different form to those arising in connection with the litigation against Argentina in the U.S.

Indeed, different tactics are likely to be deployed on a sovereign-by-sovereign basis. For example, certain Slovak and Cypriot investors in Greek bonds have recently employed novel tactics in response to the introduction of the Greek Bondholder Act in February 2012. That legislation retrospectively amended the terms of Greece's sovereign bonds by introducing collective action clauses of the type seen in the Slovenian bond documentation. That retrospective rewriting of contractual rights has led to certain investors bringing arbitral proceedings alleging that this action breached Greece's obligations under bilateral investment treaties with Slovakia and Cyprus, including the treaty provisions concerning expropriation and fair and equitable treatment. Bearing this strategy in mind, it is noteworthy that there are 37 bilateral investment treaties in force between Slovenia and other states. These include the UK (but not the U.S.).

Investors in Slovenia's debt or in its banks might be well advised to give thought to structuring or restructuring their investments so as to take advantage of additional potential treaty protections, e.g. by holding investments through an entity incorporated in a state which has a favourable investment treaty with Slovenia or restructuring existing investments in this way (before any specific dispute has arisen or is foreseeable).

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7 *See*, the Financial Markets Law Committee Report Issue 79, "*Pari Passu* Clauses".

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