

Cyprus Bailout: Potential Recourse For Lost Investments

Law360, New York (April 15, 2013, 4:19 PM ET) -- On April 2, 2013, the government of Cyprus agreed to the terms of a €10 billion bailout plan with the European Commission, the European Central Bank and the International Monetary Fund . The agreement involves a restructuring of two Cypriot banks, tax rises and privatizations in order to raise additional funds for the bailout.

Because the restructuring is designed to protect bank customers with deposits of €100,000 or less, the proposals include a “bail in” mechanism that will likely result in substantial losses for depositors with more than €100,000 at Laiki Bank and Bank of Cyprus. International arbitration and appeals to the European courts may provide legal recourse for depositors suffering losses. Whether or not this is the case, however, is likely to vary from depositor to depositor.

Background

Under the terms of the bailout plan, 37.5 percent of deposits exceeding €100,000 in Cyprus’s largest bank, Bank of Cyprus, will be converted into shares in the bank. 22.5 percent of these deposits will be temporarily frozen in a fund attracting no interest and may be subject to further write-offs. The remaining 40 percent will attract interest, but this interest will not be paid unless the bank performs well. According to the Central Bank of Cyprus, however, 10 percent has been unlocked and can be accessed by depositors. That said, Cyprus still has capital controls in place, and these controls are applicable to all Cypriot banks and allow individuals to withdraw only €300 a day and businesses to transfer only €5,000 a day to accounts abroad.

The country’s second largest bank, Laiki Bank, which became 84 percent owned by the Cypriot government following a €1.8 billion bailout in June 2012, will be wound down. Its clients’ deposits, up to €100,000, will be transferred to the Bank of Cyprus, while any deposits in excess of that will be left in Laiki Bank to cover its debts, thereby exposing those excess funds to potentially heavy losses. Laiki bondholders and other lenders to the bank are also unlikely to recover anything from the bank.

Russian nationals are estimated to hold €20 billion of the €68 billion deposited in Cypriot banks, and many are reported to have deposits exceeding €100,000. The Russian government has so far indicated that it will not help Russians who stand to lose a substantial part of their deposits in Cypriot banks, with the possible exception of state-owned companies, if any are seriously affected.

International Investment Law: International Arbitration

Bilateral investment treaties (BITs) are entered into between countries in order to protect the investments of the nationals of one country in the territory of the other. Among other things, these treaties give investors rights that protect them against expropriation or nationalization of their investments by the other contracting state. Cyprus has a number of BITs in force.[1]

A BIT was signed between the Russian Federation and Cyprus on April 11, 1997, but this treaty was never ratified by Russia and so has not entered into force. This does not mean, however, that Russian owners of deposits in Bank of Cyprus or Laiki Bank cannot take advantage of the various other BITs with Cyprus that are in force. Where deposits are held by investment vehicles based in countries that are party to those BITs, such as Luxembourg or the Seychelles, the owners may still be able to rely on the rights granted by those treaties.

Legal recourse would be by way of international arbitration via the institution prescribed in the relevant BIT, such as the International Centre for the Settlement of Investment Disputes (ICSID). To pursue such an action, depositors will need to claim that their losses from either (i) the “bail in” of Laiki Bank or Bank of Cyprus or (ii) the capital controls applicable to all Cypriot banks are an unlawful expropriation of property.

Whether or not depositors can prove that their funds have been expropriated is largely dependent on the precise way in which the restructurings of Bank of Cyprus and Laiki Bank unfold, how long any measures are in place, and the scope of the rights granted to investors under the relevant treaty.

Depositors who can show that they are entitled to be protected by these BITs may, in theory, be able to argue that Cyprus illegally deprived them of their deposits in Laiki Bank or Bank of Cyprus because the state did not compensate them effectively after the deposits were expropriated. For example, the BIT in force between Cyprus and Luxembourg would permit Cyprus, in its own national interest, to deprive Luxembourg companies of their investments only where the Luxembourg investor is compensated up to the actual value of the investment as of the day before it was expropriated. It will be difficult to prove, however, that the “bail in” was an “expropriation” and that the “value” of the deposit just before the “bail in” was more than the amount after the “bail in.”

Depositors might also have a claim under a BIT if they can show that their right to free transfer of investments was infringed by the capital controls put in place by Cyprus. The viability of such a claim will depend on whether the capital controls are temporary, as the Cypriot government claims them to be.

Claims against states in relation to bank bailouts are not unheard of. For instance, in 2012, Chinese insurer Ping An filed a request for arbitration with ICSID against Belgium in an attempt to recoup large losses from its investment in the former Belgian-Dutch bank Fortis, which was nationalized and broken up in the wake of the financial crisis.

European Union Law: European Court of Justice

Another potential avenue for recourse is an action pursuant to European Union (EU) law in the European Court of Justice (ECJ). The capital controls imposed by Cyprus may be contrary to article 65 of the Treaty on the Functioning of the European Union, which only allows member states to derogate from the principles of free movement of capital if the restrictions “are justified on grounds of public policy or public security.”

The ECJ has interpreted such justification narrowly in previous cases, and it is clear that any measures taken by Cyprus must be proportionate to their objective and must not go beyond what is necessary to attain that objective. Again, the likelihood of success will depend whether the capital controls are temporary.

Human Rights Law: European Court of Human Rights

It appears unlikely that depositors would benefit from claims pursuant to the 1950 Convention for the Protection of Human Rights and Fundamental Freedoms (the Convention), of which Cyprus is a member. Article 1 of the First Protocol to the Convention provides for the protection of property, and Article 14 states that the rights and freedoms in the Convention shall be enjoyed without discrimination. However, any claim under Article 14 cannot be freestanding and must be attached to a substantive Convention right. Therefore, it would be very difficult for a depositor to prove a breach of the right to the protection of property. This is because the European Court of Human Rights (ECHR) will consider whether the Cypriot government's actions are in the public interest, proportionate, and necessary for the general interest of the community, while giving Cyprus a wide margin of appreciation.

An interesting but untested argument might be that — taking into consideration the measures taken by other Eurozone countries in relation to bank bailouts, which have not included a “bail in” of depositors — the Cypriot “bail in” was disproportionate to the general interest of the community in that it unnecessarily violated the rights of individual depositors. Needless to say, the outcome of such a claim would be highly uncertain.

In order for a depositor to appeal to the ECJ or the ECHR, all domestic legal remedies in Cyprus must first be exhausted.

--By Peter Sharp, Bruce Johnston, Timothy Wright and Owen Hammond, Morgan Lewis & Bockius LLP

Peter Sharp is a partner in Morgan Lewis's litigation practice and co-managing partner of the firm's London office. Bruce Johnston is a partner in the firm's business and finance practice, resident in the London office. Timothy Wright and Owen Hammond are both associates in the firm's litigation practice, resident in the London office.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] View a list of Cyprus's BITs at http://unctad.org/Sections/dite_pcbb/docs/bits_cyprus.pdf.