

**3rd Annual International Seminar on Critical Issues in Financial Stability:
Preventing and Confronting Bank Insolvency**

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**Commentary on
International Aspects of Financial Insolvency:
Cross-border Insolvencies and the Case of Financial Conglomerates**

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Introduction

It is indeed an honour to address this distinguished seminar and to comment on the papers of my esteemed colleagues, Mr Baxter and Mr Nierop, speaking respectively from a US and a European perspective on international aspects of the insolvency of financial institutions, particularly conglomerates. The more complex the business, and the wider its geographical distribution, the greater the problems of an insolvency are going to be. On the other hand, many business insolvencies have a cross-border aspect. The problem is in no way unique to the financial sector. So there is a body of law and experience to draw on, and no need to despair.² My remarks are given from the perspective of the law as it applies in the United Kingdom. From that viewpoint, there are three preliminary points to make of practical importance.

The first is that because the UK has a single financial regulator, the regulatory aspects of dealing with a troubled financial conglomerate are contained within a single body. Indeed, the tendency of financial businesses to join together in conglomerates was the principal reason given for the setting up of the Financial Services Authority in 1997. This is likely to have a number of significant consequences. For example, issues as regards communication with, and division of responsibility between, internal regulatory

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² For a wider perspective, see the excellent discussions in M. Giovanoli & G. Heinrich (eds), *International Bank Insolvencies: A Central Bank Perspective* (London, Kluwer, 1999); and E. Hüpkes, *The Legal Aspects of Bank Insolvency* (The Hague, Kluwer, 2000).

bodies do not arise, though of course they arise as regards external supervisory authorities.

The second is that, unlike the United States and some other jurisdictions, the UK does not have a separate law dealing with bank insolvency. To be sure, there are provisions in the regulatory legislation which impose significant modifications, but in principle the insolvency of a bank is conducted under the general law of insolvency. One consequence is that the administration of the insolvent institution is not in the hands of the supervisory authority, but of a court appointed insolvency practitioner, the latter invariably being a partner or partners in a large firm of accountants.

The third is that though there have been some spectacular failures, the UK has not experienced significant recent episodes of bank insolvency. (Attention of UK regulators is at the time of writing concentrated rather on solvency margins of insurance companies, which have come under pressure because of the decline in the stock market.) In contrast, the rules in the United States have been conditioned by an unusually large number of banks and, therefore, of bank failures, and also the experience of the Savings and Loans crisis of the 1980s. In consequence, the Federal Deposit Insurance Corporation (FDIC) and other regulatory authorities have developed sophisticated methods of dealing with bank failures, in particular purchase and assumption transactions with other institutions, establishment of conservatorships, the provision of open bank assistance and the creation of so-called “bridge banks.”³ These provide valuable lessons for general use, so long as one remembers that the economic, political and legal framework against which action is taken in other countries may be very different.

It may also be that the generous deposit protection provisions in the United States make bank closure less painful politically than in countries where the affected savers may lose most of their money, or perhaps everything. Be that as it may, even the US regulators have no experience of the failure of an internationally active bank with extensive involvement in the OTC derivatives markets. This may prove to be the ultimate

³ A “bridge bank” is a temporary national bank organized by the FDIC to take over and maintain banking services for the customers of a failed bank. Only part of the bank’s assets and liabilities are generally transferred into the new bridge bank. The rest of the balance sheet is subject to conventional liquidation procedures.

test for both the industry and its regulators.⁴ (The nearest analogy is the case of Long-Term Capital Management (LTCM), although LTCM was not itself a bank, but a limited liability partnership, which operated a hedge fund. However it clearly demonstrated the possibility of mass contagion.)

Some practical considerations

If an institution reaches the critical stage when intervention becomes necessary, the response of the regulatory authorities is likely to be conditioned by a number of practical factors. Some of these relevant to the subject under discussion are as follows:

- The nature of the business concerned, including its size, geographical spread, importance to the local economy, and the political and social implications of the available options.
- Whether the local regulator has primary responsibility for the institution, or whether it is headquartered in another country whose regulators may be expected to take the lead in any action.
- Co-ordination between domestic regulators, eg in the case of a conglomerate, the banking and securities regulators in countries where these functions are performed separately, and with the respective foreign regulators in the other countries where it carries on business.
- The speed with which the crisis emerges, and whether the nature of the business requires urgent action, perhaps because of a possible run, or because of proprietary trading books liable to be closed out under market default mechanisms.
- The reason for the intervention, for example, liquidity problems in a potentially viable institution may require different solutions than the case of fraud on the part of the management.

⁴ See Richard Herring, *International Financial Conglomerates: Implications for Bank Insolvency Regimes*, paper prepared for Second Annual Seminar on Policy Challenges for the Financial Sector in the Context of Globalization, Washington, DC, June 2002.

- The confidence which the regulator has in the institution's management, and whether it is likely to cooperate with, or to take steps to frustrate, the proposed action, or dispose of assets.
- The action plan the regulator has in mind for the institution, for example, some form of rescue, or closure and liquidation.
- The need to comply with the requirements of local law, including procedures designed to minimise susceptibility to judicial review and subsequent court action.

Deciding on appropriate action often involves decisions of great difficulty, in which many competing interests have to be balanced by the regulatory authorities. Whatever action is taken, at least three goals will have to be pursued: (1) the fair treatment of creditors, (2) the maximisation of the value of available assets, and (3) the reduction of systemic risk. It is the last goal that differentiates bank insolvency from most other instances of corporate insolvency and which may, in certain circumstances, lead to a conflict with the other two goals.⁵ In the cross-border context, one can add a fourth, namely cooperation with action being taken in other jurisdictions.

Applicable rules

I shall now set out the rules likely to apply to cross-border insolvencies and financial conglomerates from an English law perspective. The first point to note is that cross-border considerations may arise in a number of possible fact situations. There are by definition at least two countries involved. Country A may be the country in which the institution is headquartered, or it may host one or more branches or subsidiaries. Alternatively, it may have a more tangential association, holding assets on behalf of the institution. The same applies to country B, and so on. The position of the local regulatory authorities will differ according to the relevant fact situation.

⁵ See J. Norton, R. Lastra & D. Arner, "Comparative Aspects of Depositor Protection Schemes," in J. Lin & D. Arner (eds), *Financial Regulation: A Guide to Structural Reform* (Hong Kong, Sweet & Maxwell, 2003 forthcoming), ch. 20, and Charles D Booth, *Hong Kong Insolvency Law Reform: Preparing for the Next Millennium*, [2001] J.B.L. 126.

The resultant problems have come to be classified under a number of heads. As regards the core issue of “territoriality” as against “universality”, English law traditionally does not take a doctrinaire position, preferring a middle course.⁶ Recognition is commonly given to foreign insolvency and reorganisation proceedings by the English courts. At the same time, they reserve the right to order a winding-up under English rules, if that is deemed desirable for the orderly disposition of the insolvency. An important principle is that such a winding-up may be treated as “ancillary” to foreign proceedings, if the centre of gravity is obviously in another country. Generally speaking, a pragmatic approach is adopted, and co-operation with foreign courts is the norm.⁷

Where the bank concerned is headquartered⁸ within the European Union, this approach is subject to the Directive on the Reorganisation and Winding up of Credit Institutions (Dir. 2001/24/EC) which has to be implemented in the UK, as in other member states of the EU, by 5 May 2004. The intention of the Directive is to provide for the orderly winding-up of European banks. To that extent, its effect is limited in the context of financial conglomerates, though there is an Insolvency Regulation of more general application (Council Regulation (EC) No. 1346/2000 of 29 May 2000), and a Directive dealing specifically with the reorganisation and winding up of insurance undertakings (Dir. 2001/17/EC). The Directive requires that insolvency proceedings are instituted solely in the credit institution’s home state as defined in the Credit Institutions Directive (Dir. 2000/12/EC). Broadly that is the state in which the bank has its headquarters. The rule follows from the home country control principle that underlies the regulation of banks in Europe. The Directive is essentially a choice of jurisdiction instrument: it does not seek to harmonise substantive bankruptcy law. Also, a number of important aspects of the process continue to be subject to host state law, or the law governing the relevant contract.

As the title makes clear, the Directive applies to the reorganisation of credit institutions, as well as their winding up. The mutual recognition regime of both

⁶ Philip Smart, *Cross-Border Insolvency*, 2nd edition, (Butterworths, London 1998) p.6.

⁷ *Banque Indosuez SA v Ferromet Resources Inc* [1993] BCLC 112 at 117, a case involving recognition in England of Chapter 11 proceedings in Texas.

⁸ Provision is also made for the situation in which a non-European bank has branches in more than one member state.

reorganisation measures and winding up procedures has been described as one of the more positive aspects of the Directive.⁹ On the other hand it has been said that “the slower kinds of proceedings—especially the stakeholder-centred ones—are disfavoured in bank insolvency law, and the existing faster options—liquidations, mergers, and liability transfers—are the norm. Chapter 11-style reorganisations appear disfavoured in bank insolvency law, and compositions seem extremely rare or nonexistent. One reason may be that de facto bank reorganisations often take the form of bank supervisor-overseen (or -encouraged) workouts, outside any formal insolvency process, or with the formal approval of an insolvency court as the last step.”¹⁰

There are some differences in the structure and terminology of national laws to note in this context. Laws generally provide a structure for corporate rescue as an alternative to liquidation, and this may include provision for temporary administration. Alternatively, as is well known, under Chapter 11 of the United States Bankruptcy Code, a company may continue to operate under existing management, subject to a moratorium as regards its debts. Chapter 11 does not apply to banks. But there are other corporate rescue models which differ from Chapter 11-style reorganisations. One is the appointment by the court of administrators with power to continue the business shielded from creditor action (as in the case of the administration procedures in the UK Insolvency Act, 1986). The UK procedure does apply to banks, and has been used by the regulatory authorities as the mechanism of choice when intervention of this kind is required. Whilst de facto bank reorganisations outside the formal insolvency process may often provide much the best solution, resort to the formal process may sometimes be an inevitable prerequisite for an effective restructuring.

Making sense of cross-border issues

A good starting point is to recall the general rule of private international law,

⁹ Andrew Campbell, *Issues in Cross-border Bank Insolvency: the European Directive on the Reorganisation and Winding up of Credit Institutions*, p.29.

¹⁰ Report of the G10 Contact Group on the Legal and Institutional Underpinnings of the International Financial System: Insolvency Arrangements and Contract Enforceability (September 2002), page 27. Valuable ongoing work is also being done under the Global Bank Insolvency Initiative (GBII) being led by the World Bank and the IMF and other institutions. The present issues are outside its direct remit.

which is that the law of the place of the company's incorporation governs matters such as formation, dissolution, capacity, and internal management. For this reason, there should be no difficulty in recognising the authority of administrators, conservators, liquidators etc validly appointed under that law. This is the position taken in the English courts. Such persons step into the shoes of the original management for the purposes of directing the company's affairs, and *de facto* that includes the affairs of subsidiaries, whether the administrator etc have been formally appointed over the subsidiaries under bankruptcy process, or not. The principle should extend to administrators etc appointed under the law of the place where the company carries on business (eg where its place of incorporation is for any reason different)¹¹, and where it applies, this is broadly the rule in the Winding Up Directive. This approach may be sufficient to deal with less complex cross-border situations, for example permitting administrators to get in assets, and paying off local creditors.

However, there are at least six questions which require special discussion. These arise when the institution is insolvent, in other words where rescue efforts are not feasible, or have to be abandoned, and the institution cannot meet the claims of its depositors and other creditors. Consider them against the factual scenario under discussion, that of a bank or financial conglomerate with branches or other businesses in a number of different countries.

(i) Must there be a local liquidation under local bankruptcy process, or can the local court recognise the liquidation being conducted in the country where the institution is headquartered? In the United States, the answer appears to be 'yes' to the former. A branch is treated as a separate entity, and liquidated to an extent independently. Where the European Directive applies, the answer is 'no'. The only liquidation recognised is that taking place in the home state.

(ii) Are claims on the insolvent institution ranked equally, or do creditors of branches in any particular country get paid first out of the assets available in that country? Again, the latter answer appears applicable in the United States following the so-called 'ring fencing' doctrine, which results in the "preferred treatment of local

¹¹ Smart, *ibid*, page 175.

creditors of multinational entities over creditors of offices located in other countries”.¹² Under the European Directive, which in this respect is the same as the guiding principles under pre-Directive English law, it is stated unequivocally that the “equal treatment of creditors requires that the credit institution is wound up according to the principles of unity and universality” (recital 16).

(iii) Under which law is the right of set-off defined? This is a key consideration, because as leading commentators have often said, set-off, offset, netting, etc, are fundamental concepts in finance. In a liquidation, the availability of set-off will determine the net amount of a creditor’s claim, and I have made some remarks in this regard below.

(iv) Which law governs the rights of the secured creditors? In Europe, as regards security granted by the institution, rights over security situated in another member state are broadly unaffected by the Directive.

(v) Is there an issue as to settlement finality? Probably not, because this is perhaps the one area in which there has been considerable success in harmonising the rules internationally, reducing the possibility of conflicts between the laws of different countries.

(vi) Is there an issue as regards civil or criminal penalties against the failed institution? These played a significant role in the liquidation of BCCI in the United States,¹³ I think it unlikely the UK regulatory authorities would levy such penalties *after* insolvency, reasoning that this would have the effect of diminishing the assets available to the creditors, and that the fault lay with the previous management.

Set off

The mutual set-off rule applies in the insolvency law of many (although not all) common law jurisdictions. When the conditions of the rule are satisfied, a set-off is treated as having taken place automatically on the bankruptcy date. In principle, the original claims are extinguished and only the net balance remains owing one way or the

¹² Hüpkés, *ibid*, page 143.

¹³ R.Cranston, *Principles of Banking Law*, second edition (Oxford, OUP, 2002), p.19.

other.¹⁴ The effect is to allow the debt which the insolvent company owes to the creditor to be used as security for its debt to him. The creditor is exposed to insolvency risk only for the net balance.¹⁵ It should be noted that the set-off only applies if the company is insolvent. It would not apply, for example, on the appointment of a conservator.

It may be noted in this context that while most deposit insurance schemes give fairly modest protection, the set-off rule is capable of providing considerably greater protection to depositors. If, for example, the depositor has a loan of \$ 1,000 and a deposit of \$ 500, insolvency set-off has the result that his net indebtedness to the failed bank is \$ 500. If the figures are reversed, the converse is true, and the net indebtedness of the failed bank to the depositor is \$ 500. Such set-off does not happen in all legal systems.

It does not follow that the insolvency set-off rule makes disposal of the assets of a failed bank more difficult. Although the set-off is mandatory, and the future and contingent liabilities of both creditor and debtor have to be taken into account and valued, future obligations of customers are not accelerated. To give an example, the mortgage loan book of an insolvent institution is available for realisation in a purchase and assumption-type transaction, because the set-off rule does not inhibit the loans running to term. The net amount of the loans however, would be reduced by the amount of the deposit. On this basis, the asset would be available for transfer, and the obligations of the borrower would be netted, but not accelerated.

Under the European Directive, the rights of creditors who have obtained partial satisfaction after the opening of insolvency proceedings through a set-off are determined by home state law (Article 10(h)). However, the *availability* of set-off is referred to the law applicable to the credit institution's claim (Article 23). The effect is that if a depositor with a deposit in a branch in country A has a loan from the bank governed by local law, he is entitled to set off the loan against the deposit if this is permissible under the law of country A, even if impermissible under the law of country B where the bank is headquartered. Nevertheless, this rule is more restrictive than that which applied in the UK before the Directive. In an English winding up, set-off was treated as mandatory,

¹⁴ *Stein v. Blake* [1996] AC.243.

¹⁵ *Re BCCI (No 8)* [1998] AC 214 at 223.

even if the winding up was ancillary to a liquidation in the state where the bank was headquartered.

Views doubtless differ, but I cannot help feeling that it is a pity that the drafters of the Directive did not give a nod in the direction of territoriality on this issue. Though it may not matter that often in practice, it seems a little odd to refer the question of set-off to the law governing claims *by* the credit institution. The alternative would have been to refer it to the law governing claims *on* the institution. This would have had the effect that set-off issues were governed by the law of the place of the relevant branch, which accords with the rule in private international law that bank accounts are governed by the law of the place of the branch where the account is kept, and produces greater uniformity, as well as being more in line with the expectation of local depositors.

Netting agreements are governed solely by the law of the contract which governs such agreements (Article 25). This covers a swathe of market contracts, typically with a choice of law clause. The treatment of these market contracts preserves the position as it applied before the adoption of the Directive.

Facilitating purchase and assumption transactions

At common law, assets (such as receivables), but not liabilities (such as deposits), can be transferred by assignment. An available alternative route is by way of novation, but this is not generally viable where there are large numbers of contracting parties as is the case with a financial institution. Thus, private law cannot fully provide for the transfer of banking business, whether by a conservator or otherwise which is why, in some jurisdictions, recourse may have to be had to legislation to achieve bank mergers. Since such transfers are a potential means of accomplishing a bank rescue, there may be merit in the facilitation of purchase and assumption transactions by providing for “banking business transfer schemes” to be sanctioned by the court.¹⁶ The court sanction is intended to provide some independent appraisal of the scheme, and prevent abuse. To be effective, the scheme would require to be recognised in other jurisdictions.

¹⁶ For example, Pt VII of the UK Financial Services and Markets Act 2000.

Ancillary liquidations

There is no getting round the choice presented between the territorial and the universal principle as regards the treatment of the claims of creditors. This is a policy choice for each jurisdiction. In practice, however, whatever the attraction of the doctrine of universality, a local liquidation may be the best (perhaps the only) way to get in assets, and deal with claims in an orderly manner. Within the limits of local law, the various liquidations will have to work to a common purpose, under unified control.

In this regard, the bankruptcy process of the state where the conglomerate was headquartered is likely to play a central role. There is legal precedent that shows that liquidations in other countries can be regarded as ancillary to the main liquidation. The issue occurred, for example, in the course of the liquidation of BCCI, which was incorporated in Luxembourg, the place of the principal liquidation, and had its main place of business in England, the place of the ancillary liquidation, but the principle can apply in any cross-border fact situation.

The court held that¹⁷ where a foreign company is in liquidation in its country of incorporation (country A), a winding-up order made in country B will normally be regarded as giving rise to a winding-up ancillary to that being conducted in the country of incorporation. The winding up in country B will be ancillary in the sense that it will not be within the power of the local liquidators to get in and realize all the assets of the company worldwide. They will necessarily have to concentrate on getting in and realizing the local assets. Since in order to achieve a *pari passu* distribution between all the company's creditors, it will be necessary for there to be a pooling of the company's assets worldwide and for a dividend to be declared out of the assets comprised in that pool, the winding up in country B will be ancillary in the sense, also, that it will be the liquidators in the principal liquidation who will be best placed to declare the dividend and to distribute the assets in the pool accordingly. Nonetheless, the ancillary character of the local winding up does not relieve the courts of country B of the obligation to apply local law, including insolvency law, to the resolution of any issue arising in the winding up,

¹⁷ This paragraph is adapted from *In re Bank of Credit and Commerce International S.A. (No.10)* [1997] Ch. 213 at 246, a decision of the English Chancery Division.

which is brought before the court. It may be, of course, that the local conflicts of law rules will lead to the application of some foreign law principle in order to resolve a particular issue.

As regards English law, these principles have to be read subject to the European Directive where it applies. But whatever the precise rules adopted, it is obvious that the orderly liquidation of a financial conglomerate will require not only cross-border cooperation, but probably a lot of innovation as well.