

**APPENDIX A:**

**CROSS-BORDER ASPECTS OF INSOLVENCY**



# CROSS-BORDER ASPECTS OF INSOLVENCY

## Table of contents

1.	Introduction .....	A5
2.	Cross-border insolvency .....	A7
2.1	Risks and cross-border issues .....	A7
2.2	Different perspectives - shared objectives .....	A10
2.3	International rules and sources of law .....	A13
2.3.1	International treaties and conventions .....	A13
2.3.2	The UNCITRAL Model Law and other international rules .....	A14
2.3.3	The new EU regime on cross-border insolvency .....	A16
2.3.4	Private international law .....	A17
2.3.5	Principles of law applicable to international insolvency cases .....	A17
2.3.6	Comity of law .....	A19
3.	Insolvency proceedings and cross-border aspects .....	A20
3.1	Recognition of foreign insolvency proceedings .....	A20
3.2	Enforceability of financial contracts .....	A21
3.3	Cross-border dimensions of special bank procedures and general insolvency proceedings .....	A24
3.4	Cross-border dimensions of liquidation and reorganisation .....	A24
4.	Legal regimes for cross-border insolvency .....	A25
4.1	European Union .....	A25
4.1.1	The EU legal acts and the underlying principles .....	A25
4.1.2	The Winding-up Directive for credit institutions .....	A29
4.1.3	The carve-outs of the Winding-up Directive for credit institutions .....	A30
4.1.4	The EU insolvency regime in an international context .....	A31
4.2	Italy .....	A31
4.2.1	Insolvency law in general .....	A31

4.2.2	National treatment of cross-border insolvency issues .....	A32
4.2.3	Insolvency law reform .....	A32
4.3	Netherlands .....	A33
4.3.1	Insolvency law in general .....	A33
4.3.2	National treatment of cross-border insolvency issues .....	A33
4.3.3	Insolvency law reform .....	A34
4.4	United Kingdom .....	A34
4.4.1	Insolvency law in general .....	A34
4.4.2	National treatment of cross-border insolvency issues .....	A35
4.4.3	Insolvency law reform .....	A36
4.5	United States .....	A37
4.5.1	Insolvency law in general .....	A37
4.5.2	National treatment of cross-border insolvency issues .....	A37
4.5.3	Insolvency law reform .....	A38
5.	The legal and institutional underpinnings of cross-border insolvency .....	A38

## 1. Introduction

In the past few decades the world has experienced a number of banking crises which have heightened the awareness and understanding of the causes, problems and potential risks and costs connected with the insolvency of banks and other financial institutions. As a result, there is today an increasing recognition in most countries of the importance of the adoption of adequate policies and of the effectiveness of the legal, institutional and regulatory framework for the treatment of insolvent financial institutions within their national boundaries. However, many of the recent insolvencies of financial institutions, such as the BCCI and the Barings insolvencies, have also been characterised by a strong cross-border dimension. In such international insolvency cases, where the insolvent entity may have establishments and assets, as well as creditors and debtors, in many countries, a further layer of complexity is added to an already complicated situation.

The increased level of cross-border commercial and financial activity, on the one hand, and the general territorial limitations of national insolvency laws, on the other, explain the attention given to cross-border insolvency by a number of international financial institutions over the last few years.<sup>1</sup> “The increasing incidence of cross-border insolvencies reflects the continuing global expansion of trade and investment. However, national insolvency laws have by and large not kept pace with the trend, and they are often ill-equipped to deal with cases of a cross-border nature. This frequently results in inadequate and inharmonious legal approaches, which hamper the rescue of financially troubled businesses, are not conducive to fair and efficient administration of cross-border insolvencies, impede the protection of the assets of the insolvent debtor against dissipation, and hinder maximisation of the value of those assets.”<sup>2</sup>

The G10 Contact Group on the legal and institutional underpinnings of the international financial system (the Contact Group) has considered the legal and institutional arrangements for the resolution of insolvent financial institutions and of non-financial institutions that have substantial financial activities. The Contact Group has examined how resolution of insolvent institutions takes place both under general insolvency regimes and under special rules applicable only to particular categories of institutions (such as banks, insurance companies and non-financial corporations with significant financial activity) or to a particular type of transaction or operation (including the taking of collateral, the finality of settlement of transfers of funds or securities and netting transactions). The findings of the Contact Group are set out in a main report on the legal and institutional underpinnings of the international financial system (the main report).

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<sup>1</sup> For an overview of the efforts of international organisations addressing the topic of cross-border insolvency, see Group of Thirty, *Reducing the risks of international insolvency* (2000).

<sup>2</sup> ‘Guide to enactment of the UNCITRAL Model Law on cross-border insolvency’, A/CN.9/442 (December 1997), at para 13.

In view of the importance of the cross-border dimensions of the resolution of large internationally active institutions, a particular focus of this examination has been the resolution of institutions that conduct a wide range of activities on a large scale in many countries. One multifaceted aspect of this dimension is the functioning of existing insolvency regimes in international cases and the treatment of the various cross-border issues that may arise in such insolvency proceedings. These cross-border aspects of insolvency are considered in this supplementary report (the cross-border insolvency report).

Since law and legal rules are territorially bound and generally national in nature, the Contact Group has - as a first step - conducted two comparative surveys of the legal situation in the jurisdictions represented within the group, namely the European Union, Italy, the Netherlands, the United Kingdom, the United States and Japan. The geographic scope of this exercise has been discussed within the Contact Group and, although it may be extended to additional jurisdictions at a later point in time, the intention is to provide an indication of how the issues raised can be addressed even if other legal and institutional arrangements may exist in other jurisdictions. The first of the two surveys conducted by the Contact Group considers how legal and institutional arrangements may impinge on the efficiency and robustness of financial institutions through insolvency arrangements and the resolution of financial institutions through insolvency arrangements (the insolvency survey). The results of the insolvency survey are presented in a separate document annexed to the main report. The second survey considers how legal and institutional arrangements may impinge on the efficiency and robustness of financial markets and the effect of insolvency arrangements for financial institutions on the performance of contracts (the contract enforceability survey). The outcome of the contract enforceability survey is also annexed to the main report. Certain aspects of the insolvency and contract enforceability surveys are also reflected in this cross-border insolvency report since many of the cross-border issues related to insolvency have to be investigated against the background of the national (or, for the European Union, the supranational) legal regimes applicable in the respective jurisdiction.

Chapter 2 of this report discusses the risks and issues connected with cross-border insolvency (2.1) and some different perspectives on the topic (2.2). It also considers in general terms the international rules and the different types of sources of law in this field (2.3). The conduct of insolvency proceedings involving cross-border elements is considered in Chapter 3, in particular when the insolvent entity (or group of entities) has establishments in several countries. The focus of Chapter 3 is on the issues related to the recognition of foreign insolvency proceedings (3.1) and the enforcement of financial collateral arrangements in international insolvency cases (3.2). This chapter also considers the possible additional complexity of international insolvency proceedings dependent on whether a distinction is made between banks, to which special insolvency procedures may apply, and non-banks, or whether no such distinction is made and only general insolvency procedures apply (3.3) and certain problems which may arise in cross-border insolvencies with regard to the choice between liquidation and reorganisation (3.4). Chapter 4 provides a summary of the legal situation with specific focus on the treatment of cross-border insolvencies in certain jurisdictions represented within the Contact Group. In the European Union, the existence of

an internal market with an incomplete harmonisation of national insolvency regimes gives rise to particular difficulties for market participants and national authorities. In view of the introduction of the euro, the desirability of a well functioning cross-border insolvency regime has become more apparent. The problem of cross-border insolvencies within the European Union has been addressed recently through the adoption of a legal framework for cross-border insolvency cases, which is described in Chapter 4.1. The objective of the new EU legal acts in this field is primarily to secure the mutual recognition and coordination of reorganisation and winding-up procedures in EU member states. The following sections outline the national treatment of cross-border insolvencies in Italy (4.2), the Netherlands (4.3), the United Kingdom (4.4) and the United States (4.5). Finally, a concluding Chapter 5 contains some reflections concerning the present situation with regard to the cross-border aspects of the legal and institutional underpinnings of international insolvency situations.

## **2. Cross-border insolvency**

### **2.1 Risks and cross-border issues**

There are a number of potential problems and risks connected with the insolvency of financial institutions and institutions active in the financial markets, some of which are of particular relevance in cross-border insolvencies. There are also numerous issues which arise specifically in international insolvency cases. Many of these latter cross-border insolvency issues are of a legal nature and stem from the national character of the applicable insolvency regimes.

One type of risk has been the subject of much analysis, namely settlement risk. In the present context, settlement risk can be described as the risk a bank would face if its counterparty failed to effect a payment or a delivery of securities because of insolvency, leading to the lack of settlement of the transaction. It follows from this description that insolvency law is an important component of settlement risk. One of the most recent examples of how settlement risk can be addressed through legislative means is Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems<sup>3</sup> (the Settlement Finality Directive), which has now been implemented in national legislation by all EU member states. The Settlement Finality Directive takes, as a point of departure, the Lamfalussy Report of 1990 to the Governors of the central banks of the G10 countries and its analysis of the systemic risk inherent in payment systems. The most important overall aim of the Directive is to reduce such risk through the provision of finality of settlement of transfers of funds and securities through payment and securities settlement systems, even in the case of insolvency, and through certain provisions on the enforceability of collateral security, as well as provisions on the law applicable to rights to securities held in book-entry form.

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<sup>3</sup> OJ L 166, 11.06.1998, pp 45-50.

The failure to settle financial transactions is an example of an event which may lead to liquidity problems. In integrated markets, liquidity risk may in most cases be related to cross-border events and it is consequently not a country-specific problem. However, it is possible that a lack of liquidity within a particular country may occur in certain situations, even when its economy is basically sound, such as a loss of market confidence due to external developments elsewhere in a particular market sector which has a certain weight in the structural market setup of the country in question. In today's global financial market, the important point is to avoid the spread of such liquidity problems and their becoming a problem of solvency. Insufficiency of available funds at a particular point in time should be prevented from resulting in insolvencies.

When insolvencies occur, one main objective is the containment of the problem. In this connection, one type of risk of particular relevance with regard to cross-border insolvency aspects related to large financial institutions is systemic risk. It is generally recognised that one bank's failure may lead to the failure of many banks,<sup>4</sup> thus causing a chain reaction and widespread failures and the realisation of systemic risk.<sup>5</sup> Adequate insolvency regimes can contribute to the avoidance of such chain reactions, and thereby systemic risk, by allowing for orderly liquidation or appropriate reorganisation measures and by ensuring that collateral security rights can be enforced and the performance of contracts honoured.

Once insolvency is imminent, there are several issues to be considered with regard to the cross-border aspects in international cases, many of which can be derived from the territorial limitation of the effects of the insolvency laws of the home jurisdiction of an insolvent internationally active institution. The insolvent entity may not only have assets abroad - including claims against companies located in various countries - but also subsidiaries which might themselves be insolvent, and it is therefore possible that insolvency proceedings are begun concurrently in several jurisdictions. Moreover, the various creditors are likely to be established in different countries and since these countries may have different insolvency laws, some more creditor-friendly than others, individual creditors might engage in forum shopping in order to obtain maximum satisfaction for their claims from assets located in countries other than the institutions' home country. In such cases, the effectiveness of a decision on a moratorium on the exercise of rights against the insolvent institution and its property with the aim of obtaining an orderly resolution, or a rescue effort and the reorganisation of the entity, may be hampered. According to the principle of the universality of the insolvency proceedings, the appointed trustee of the insolvent estate is expected to obtain all property belonging to the estate and conduct an orderly realisation of all assets for the benefit of the creditors. Hence, the application of this principle could address many of the issues arising in cross-border insolvencies, as further discussed in relation to the new EU regime on insolvency (see 4.1 below). However, territorial limitation will mainly become a

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<sup>4</sup> See Viral Acharya, *A Theory of systemic risk and design of prudential bank regulation*, p 1.

<sup>5</sup> Systemic risk is "the risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default, with the chain reaction leading to broader financial difficulties" (*Bank for International Settlements, 64th Annual Report*, p 177).



problem in cases of substantive incompatibility between different insolvency regimes, for instance as regards netting rules.

Although the international trend is for the home state to collect the assets of insolvent institutions wherever geographically located, and not just its local property, there is still a potential scope for conflicts. For instance, the rules regarding the treatment of subsidiaries within a group of insolvent companies have not been harmonised in all countries. Some jurisdictions apply the law of the main place of establishment to the insolvency of all entities within a group of companies affected by the bankruptcy. However, many countries do not have any provisions addressing the insolvency of a group of companies, which may lead the national authorities of the place of incorporation and/or establishment of the affiliated subsidiaries to claim jurisdiction over the local part of the group's insolvency to the benefit of the creditors of that jurisdiction, which would then have access to the local assets of the subsidiary.

Another area of added complications due to the connections of international insolvency cases to different countries is the treatment of collateral and its realisation. Legal uncertainty in this respect will play a role irrespective of whether or not a party to a financial collateral arrangement will in fact become insolvent. The smooth functioning of the international financial system is to a certain degree dependent on financial agents having the possibility to interact with one another and make collateral arrangements to cover their potential exposures should one of the entities involved become insolvent. It must therefore be possible for financial institutions and other entities active in the financial markets to determine in advance the steps necessary to take in order to perfect a collateral interest in such a manner that the collateral security can be realised without undue delay in case of insolvency. One specific issue with regard to collateral is the validity of repurchase agreements and other transfer of title mechanisms. Accordingly, the national rules governing the subject must be sufficiently clear and their application predictable. In addition, and as a prior step in the process, a collateral taker must have sufficient legal certainty with regard to potential conflict-of-law issues arising in international transactions. In other words, the private international law rules of the jurisdictions to which a collateral transaction is connected will need to provide clear answers to the question of which country the collateral taker has to look in order to find the laws applicable to a particular aspect of the collateral arrangement.

These types of issues are relevant not only with regard to collateral in a limited sense, but also to specific collateral security arrangements between the parties which are designed to enhance the protection of the creditor (such as top-up collateral in cases where the value of the collateral has decreased, substitution of collateral assets at a later point in time during the relationship and the possibility for the collateral taker to reuse collateral received under a pledge agreement). This area includes insolvency set-off and other netting and closeout arrangements intended to take effect in case of insolvency. In this context, it may be mentioned that the recent Directive of the European Parliament and of the Council on

financial collateral arrangements<sup>6</sup> (the EU Collateral Directive) is intended to address these legal uncertainties with regard to the cross-border use of collateral between EU member states. The main objective of the proposed EU Collateral Directive is to provide a clear and predictable regime, including conflict-of-law rules, for, inter alia, banks and financial institutions with regard to the taking of financial collateral consisting of transferable securities and cash.

## **2.2 Different perspectives - shared objectives**

The risks and issues related to cross-border aspects of insolvency are of concern to various interested parties and, consequently, can be seen from different perspectives. Since all of these interests are valid, it would seem appropriate for any policy position to take these different viewpoints into account. Moreover, there may in certain areas be a need to find the correct balance between such interests in order to design an acceptable policy response to address potential threats to the international financial system in this field. On the other hand, the overall objective of the maintenance of financial stability represents an ultimate goal which is shared by all parties concerned.

In the case of insolvency of credit institutions, public policy considerations may be involved. For instance, national treasuries may consider whether to rescue an insolvent credit institution or not. Within the European Union, this fact may lead to the application of state aid rules giving an additional layer of complexity in the application of insolvency law with regard to credit institutions, from both a national and a cross-border perspective.

Depending on the degree of distinctions which may be drawn between different categories of interests, and whether borderlines are drawn on the basis of even small differences of views, the division into groups of interested parties can result in a very long list (including, for instance, creditors and debtors and, indeed, different types of creditors which may form their own categories representing very specific interests). On the other hand, it is also possible to divide them only into a few main groups considering the more generic interests that they represent. We have chosen the latter broad generic division and distinguish between (i) market participants; (ii) supervisory authorities and central banks (which may or may not also be entrusted with supervisory functions); and (iii) society at large (which, for the present purposes, refers to the societal interest as evidenced by the policies and institutional and other arrangements existing in a particular country, whether directly related to insolvency or not).

Market participants will benefit from a high degree of robustness of the legal and institutional infrastructure underpinning the financial system within which they operate. They particularly favour the existence of clear and predictable legal and institutional arrangements. They are generally in a good position to assess their situation and predict the consequences of their actions within a domestic context, at least in comparison with their cross-border activity. However, the increasing level of cross-border trade and truly international financial agents, as well as large corporations with substantial financial dealings, have made market participants

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<sup>6</sup> Directive 2002/47/EC of 6 June 2002, OJ L 168/43.

more aware of the added risks and complexities related to the possible insolvency of one of their international counterparties. For markets to operate in an effective manner, market participants will need to achieve a sufficient level of understanding of such risks.

Although market participants will naturally wish to have the most favourable treatment in their capacity as creditors in an insolvency situation, they are also well served by clear insolvency regimes providing for the orderly resolution of insolvent financial institutions and other financial counterparties that they may have. In addition, market participants generally welcome simple, effective and cost-efficient rules for the taking of collateral in order to minimise their transaction costs. In particular, market participants generally attach a high value to legal certainty and predictability with regard to their financial collateral arrangements. In other words, market participants would like to have clear answers to the questions concerning the law applicable to their dealings in order to avoid having to comply with the legal regimes of several jurisdictions and will generally benefit from rules that ensure the enforceability of their contractual arrangements concerning, inter alia, the provision of collateral.

Supervisory authorities and central banks have a common interest in financial stability and, hence, attach importance to the avoidance of settlement risk and systemic risk developments which may threaten the stability of financial markets. Accordingly, a traditional point of attention is the need to contain the problem which an insolvent financial institution may pose to other institutions and the financial system. Another aspect is the need for orderly insolvency proceedings and the possibility of rescuing the insolvent entity through reorganisation measures rather than liquidating its assets. In a BIS study carried out in 1992,<sup>7</sup> a number of areas were identified as raising uncertainty and the potential for conflict in view of the lack of internationally agreed procedures for the liquidation of multinational banks. The main areas identified were the following:

- (a) banking supervisors should pay attention to the nature and timing of communications among themselves and with creditors, shareholders and management;
- (b) the nature of the rules concerning liquidation may be relevant to the manner in which multinational banks are supervised;
- (c) differences in liquidation rules across jurisdictions in a winding-up situation can affect the returns to depositors and other creditors and the operations of deposit protection schemes;
- (d) the coordination and cooperation between liquidators can affect the return to creditors and can be affected by the role of the supervisory authorities in a liquidation. The role of the

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<sup>7</sup> Bank for International Settlements, *The insolvency liquidation of a multinational bank* (1992). The Basel Committee used the liquidation of BCCI to illustrate some of the issues arising from the insolvency of a multinational bank.

supervisors varies across jurisdictions; in some jurisdictions they may be in charge of the liquidation, in others they may appoint the liquidator.<sup>8</sup>

In addition, central banks also consider the effects that insolvency might have from their operational perspective since the insolvent institution may also be a counterparty in their monetary policy operations or operations related to the management of foreign reserves and/or a participant in payment systems, whether such a system is operated by the central bank or subject to its oversight.

The policy choices relative to a new insolvency regime which may be chosen by a particular country will have to fit into its existing overall legal and institutional framework. This framework includes not only practical aspects, such as the general rules for judicial proceedings, but also the policy choices made with respect to the distribution of risks and benefits between competing interested parties. It is therefore important to take into account the societal perspective when matters of insolvency law are considered - looking at all of the relevant policies and legal and institutional arrangements already adopted and existing within a given country. At a general level, insolvency law reflects two dimensions - how to maximise the value of the insolvent entity's assets and how to allocate these between all those affected by the insolvency, including creditors but also other stakeholders, such as the state and employees. The weight attached to different aspects of these dimensions varies between societies. For instance, the main focus may be on the integrity and efficiency of financial markets. Different societies, and their legal systems, differ in their respective degree to which they are debtor- or creditor-friendly. In summary, the main public interests at stake in the insolvency of credit institutions may be identified as public confidence, stability of markets and protection of creditors and depositors.

Despite these perspectives representing potentially different views on the topic, the basic requirement with regard to the stability of financial markets is an objective which is generally accepted by all interested parties and in most societies, especially after the experiences gained from the banking crises that have occurred around the globe in recent years. In view thereof, and although different societies may place varying degrees of emphasis on certain societal priorities with relevance for the shaping of their insolvency laws, there cannot be disagreement on the overall objective of avoiding systemic risk and financial instability, particularly in view of the magnitude of the problems that could otherwise materialise in financial markets. Hence, the need for efficient and effective insolvency regimes has gained recognition as a means of contributing to the maintenance of financial stability.

For instance, insolvency appears as an important item among the 12 standards for stable financial systems recently introduced by the Financial Stability Forum.<sup>9</sup> With reference to

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<sup>8</sup> Compare Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding-up of credit institutions (the Winding-up Directive for credit institutions), OJ L 125, 5.5.2001, p. 15, which addresses most of these concerns with regard to the European Union (see 4.1 below).

<sup>9</sup> Final report of the follow-up group on incentives to foster implementation of standards, 11 September 2001, p 8, at [www.fsforum.org](http://www.fsforum.org). Other publications include UNICTRAL, *Draft legislative guide on insolvency law*

these standards, action to enhance the stability of financial systems may be considered on at least two levels. Firstly, market participants need to understand and assess the insolvency risks involved in their investment strategies. In parallel, on the macro level, it is imperative to create safeguards by implementing in all jurisdictions the internationally recognised standards.<sup>10</sup> The effectiveness of such efforts is not unconnected to the applicable rules on insolvency, including the treatment of cross-border insolvency issues both at the international level and within specific countries.

## **2.3 International rules and sources of law**

Before considering existing insolvency law regimes and reform projects of relevance to international insolvency issues, it is useful to have an understanding of the existing international rules and the different sources of law which play a role in this field. In this respect, it is possible to distinguish between (i) international treaties and conventions; (ii) other international rules and model laws; (iii) the special case of the European Union; (iv) private international law; (v) recognised principles of law in the field of cross-border insolvencies; and (vi) comity of law.

### **2.3.1 International treaties and conventions**

In view of the many issues that can arise due to conflicting insolvency laws in different jurisdictions, insolvency treaties between countries have a rather long history,<sup>11</sup> although most of the international treaties negotiated to resolve such conflicts are bilateral or involve very few countries. An inventory of international insolvency treaties can be found in, for instance, Wood's "Principles of International Insolvency".<sup>12</sup> From such an inventory, it is apparent that none of the existing treaties or conventions have a geographical scope wide enough to address the problems discussed in this report. Only a few examples can be given of multilateral treaties with a somewhat more extended coverage, the Nordic Bankruptcy Convention of 1933 and the Montevideo and Bustamante Conventions with regard to Latin America. The reason for this limited scope may be due to the importance attached to insolvency policies in individual countries and the resulting difficulties in reconciling the legislative choices made with regard to insolvency legislation in the societies concerned. For instance, Wood describes the Nordic Bankruptcy Convention as "a good example of a bankruptcy convention between

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(2001); Group of Thirty, *Reducing the risks of international insolvency* (Washington D.C., 2000); IMF, 'Orderly and effective insolvency procedures', *Key Issues* (1999); World Bank, 'Principles and guidelines for effective insolvency and creditor rights systems', *Principles* (April 2001).

<sup>10</sup> Lassen Flemming, 'The challenges of the new financial economy: the efforts of the IMF to reduce the risk of financial crises', at [www.imf.org](http://www.imf.org).

<sup>11</sup> For example, Verona and Trent concluded a treaty in 1204 that governed the transfer of a debtor's assets, and Verona and Venice reached an agreement in 1306 which sanctioned the extradition of fugitive debtors. For more details, see Philip R Wood, *Law and practise of international finance - principles of international insolvency* (1995), p 291.

<sup>12</sup> See Chapter 17 on international insolvency treaties in Wood, *op cit*.

countries which share similar attitudes to insolvency policies and hence have confidence in the suitability of each other's legal systems".<sup>13</sup>

### 2.3.2 *The UNCITRAL Model Law and other international rules*

With the notable exception of the recent adoption of the new EU regime on insolvency, there are few examples of insolvency rules at an international level. One of the most important examples of such rules is the model law prepared in 1997 by the United Nations Commission on International Trade Law (UNCITRAL) - the UNCITRAL Model Law on Cross-Border Insolvency (the UNCITRAL Model Law).<sup>14</sup> Another example is the Cross-Border Insolvency Concordat, which was approved by the Council of the Section on Business Law of the International Bar Association (IBA) in September 1995 (the Cross-Border Insolvency Concordat).<sup>15</sup> Both of these initiatives provide flexible and practical solutions to the many issues and problems arising in a cross-border insolvency context.

As its name suggests, the UNCITRAL Model Law is an example of the kind of law a particular country may wish to adopt. It explicitly aims to provide mechanisms for dealing with cross-border insolvency cases in order to promote cooperation between courts in different jurisdictions, legal certainty for investors, fair and efficient administration of cross-border insolvency proceedings and facilitation of the rescue of financially troubled enterprises. "The Model Law respects the differences between national procedural laws and does not attempt a substantive unification of insolvency law. The solutions offered by the Model Law include the following:

- (1) providing access for the person administering a foreign insolvency proceeding ('foreign representative') to the courts of the enacting state and allowing the courts in the enacting state to determine what relief is warranted for optimal disposition of the insolvency;
- (2) determining when a foreign insolvency proceeding should be accorded 'recognition', and what the consequences of recognition may be;
- (3) providing a transparent regime for the right of foreign creditors to commence, or participate in, an insolvency proceeding in the enacting state;
- (4) permitting courts in the enacting state to cooperate more effectively with foreign courts and foreign representatives involved in an insolvency matter;
- (5) authorising courts in the enacting state and persons administering insolvency proceedings in the enacting state to seek assistance abroad;

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<sup>13</sup> Wood, *op cit*, p 293.

<sup>14</sup> The UNCITRAL Model Law was adopted by the United Nations Commission on International Trade Law at its 30th session in Vienna, Austria, in May 1997.

<sup>15</sup> For details concerning the Cross-Border Insolvency Concordat, see Leonard (1996) 24 International Business Law 2 or 3 and (1997) 6.I.I.R. 127 or Barratt (1996) 24 International Business Law 208.

(6) providing for court jurisdiction and establishing rules for co-ordination where an insolvency proceeding in the enacting state is taking place concurrently with an insolvency proceeding in a foreign; and

(7) establishing rules for co-ordination of relief granted in the enacting state in favour of two or more insolvency proceedings that take place in foreign states regarding the same debtor.”<sup>16</sup>

It should be noted that the UNCITRAL Model Law applies to insolvent entities in general. Furthermore, it contains an optional clause whereby special insolvency regimes applicable to, for instance, banks or insurance companies may be excluded from its scope.<sup>17</sup> Hence, the UNCITRAL Model Law is not specifically tailored to address insolvency proceedings involving financial institutions. It has also been remarked in the comments to the UNCITRAL Model Law that the reason for special regulation on winding-up of credit institutions may be that particularly prompt and circumspect action is called for in relation to such entities from the competent authorities.<sup>18</sup> This might be interpreted as a caveat that it might not be able to meet the demands for speedy adjudication posed by the financial markets. In jurisdictions where the UNCITRAL Model Law is adopted, financial institutions would be subject to the general rules on insolvency laid down by it if the optional exclusion clause is not applied.

The issues addressed by the UNCITRAL Model Law include the access of foreign representatives and creditors to courts in the adopting state. In this regard, it states that a foreign administrator can have access to the courts of the enacting state and allows the courts in the enacting state to determine the relief that may be available. Moreover, a transparent regime is set up with regard to the right of foreign creditors to commence or participate in insolvency proceedings in the enacting state.<sup>19</sup> Furthermore, the Model Law provides guidelines concerning the recognition of foreign proceedings and the consequences of such recognition.<sup>20</sup> Rules on cooperation with foreign courts and representatives are set out, authorising courts and competent authorities in the enacting state to seek assistance abroad.<sup>21</sup> Rules regarding co-ordination when insolvency proceedings in the enacting state are taking place concurrently with proceedings in another state are also given. In this section, rules are laid down in order to coordinate relief granted in the enacting state in favour of two or more insolvency proceedings that take place in foreign states regarding the same debtor.<sup>22</sup> The

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<sup>16</sup> Paper by J Sekolec, ‘The UNCITRAL Model Law on Cross-Border Insolvency’, in M Giovanoli and G Heinrich (eds) *International bank insolvencies - a central bank perspective* (1999), pp 338f.

<sup>17</sup> Article 1 (2) of the UNCITRAL Model Law.

<sup>18</sup> Article-by-article comment on the UNCITRAL Model Law, Article 1 (2).

<sup>19</sup> Articles 9-14 of the UNCITRAL Model Law.

<sup>20</sup> Articles 15-24 of the UNCITRAL Model Law.

<sup>21</sup> Articles 25-27 of the UNCITRAL Model Law.

<sup>22</sup> Articles 28-32 of the UNCITRAL Model Law.

Model Law also provides that exceptions from the general rules in certain cases may be made with regard to, inter alia, secured claims, set-off and execution of rights in rem.<sup>23</sup>

Issues pertaining to the choice of applicable law are not addressed in the UNCITRAL Model Law to the same extent as in the new EU legislation in the field of cross-border insolvency<sup>24</sup> further described below. However, the Model Law introduces a distinction between normal foreign proceedings and such proceedings that are qualified as “main” proceedings. The designation of a foreign proceeding as a main proceeding (as a foreign proceeding which takes place in the country where the debtor has its centre of main interests)<sup>25</sup> may affect the nature and scope of the relief accorded to the foreign representative.<sup>26</sup>

The other example of international rules is the IBA’s Cross-Border Insolvency Concordat which “has been designed as something in the nature of a ‘road map’ to assist insolvency practitioners actually faced with concurrent proceedings in relation to the same debtor in two or more different jurisdictions. Rather than leaving the insolvency practitioners to start from scratch and try to forge a one-off agreement (acceptable to their respective courts) as to the proper coordination of the two sets of proceedings, the Concordat sets out a small number of essential principles which can be adopted, with appropriate modification, to suit the particular facts involved. Experience has revealed the sorts of issues which are likely to be raised where there are concurrent reorganisations or liquidations; and the Concordat provides a clear and ready-made basis for negotiation at the earliest stages of the process.”<sup>27</sup>

### **2.3.3 The new EU regime on cross-border insolvency**

In addition, the new legal regime on insolvency within the European Union is an important set of recently adopted legal rules addressing specifically cross-border insolvency issues applicable within a region consisting of several countries. By the same token, the EU rules clearly represent a special case, not comparable with other attempts of international rule-making, given that this new European cross-border insolvency regime was adopted within the existing EU legal and institutional framework. However, despite the well-established EU legislative arrangements, and the clear need to address EU-wide cross-border insolvencies, this initiative was difficult to conclude and was under consideration for over a decade before its adoption. In the end, these efforts led to the adoption of three legal acts with respect to the insolvency of different categories of legal entities.

A regulation on insolvency proceedings was adopted to cover legal entities other than credit institutions, insurance undertakings, investment firms and collective investment schemes, and

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<sup>23</sup> Article 20 (2) of the UNCITRAL Model Law.

<sup>24</sup> The Insolvency Regulation (EC) No. 1346/2000 of 29.5.2000, the Winding-up Directive for insurance undertakings 2001/17/EC of 19.3.2001 and the Winding-up Directive for credit institutions 2001/24/EC of 4.4.2001.

<sup>25</sup> Article 2 (c) of the UNCITRAL Model Law.

<sup>26</sup> See, for example, Article 19 (4) of the UNCITRAL Model Law.

<sup>27</sup> Smart, *Cross-border insolvency* (1998), p 7.



two directives have been adopted concerning the winding-up and reorganisation of insurance undertakings and of credit institutions.<sup>28</sup> These recently adopted EU-wide legal acts will ensure the mutual recognition and coordination of national insolvency proceedings, although insolvency laws will still generally fall within the national competence of the member states. The new EU regime on insolvency and the rules concerning the reorganisation and liquidation of credit institutions are presented in more detail in 4.1 below.

#### **2.3.4 *Private international law***

In view of the international nature of the issues under consideration, one important type of legislation addressing these issues is private international law. The body of rules referred to as private international law forms part of the legal regime of each country and is, in this sense, domestic in nature and can differ from country to country. Fundamentally, private international law mainly addresses the following three questions in relation to cases with connections to more than one jurisdiction: (a) Which country's courts are competent to deal with a specific matter? (b) Which country's laws should apply to a particular issue? (c) Is a judgment or decision by a judicial authority recognised and enforceable in a specific other country?

In other words, private international law does not essentially address issues of substance. Instead, this body of law can rather be seen as a set of rules and principles indicating where substantive questions can be pursued, the rules which will apply in order to answer them and whether the answer is useful in the sense of being recognised and enforceable elsewhere. The substance of the matter itself is still dependent on the laws of the country identified under the second question referred to above. Hence, the substantive questions with regard to cross-border insolvency issues are subject to the various national insolvency laws, which may or may not be reconcilable with one another in insolvency cases involving several such countries' laws, including in cases of concurrent insolvency proceedings. On the other hand, the insolvency laws of some legal systems claim to have extraterritorial effect, although this may not be recognised in the jurisdiction where extraterritoriality is supposed to take effect.

#### **2.3.5 *Principles of law applicable to international insolvency cases***

Although there are no comprehensive international sources of applicable law in force which address and solve the issues related to cross-border insolvency, there exist a number of legal

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<sup>28</sup> Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings (the EU Insolvency Regulation), OJ L 160, 30.6.2000, pps 1-18. The EU Insolvency Regulation became effective and directly applicable in all EU member states on 31 May 2002.

Directive (EC) No. 2001/17 of the European Parliament and Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings (the EU Winding-up Directive for insurance undertakings), OJ L 110, 20.4.2001, pps 28-39. Member states are required to implement the Winding-up Directive for insurance undertakings into their respective national legal regimes by 20 April 2003.

Directive (EC) No. 2001/24 of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding-up of credit institutions (the EU Winding-up Directive for credit institutions), OJ L 125, 5.5.2001, pps 15-23. The timeframe for member states to implement the Winding-up Directive for credit institutions is 5 May 2004.

principles applicable to international insolvency cases. The application of these principles assist in addressing cross-border aspects of insolvency and often determine the private international law of a specific country with regard to the conflict-of-law questions that may arise. Such international legal principles are presented by Devos in his paper “Specific cross-border problems regarding bank insolvencies and European harmonisation efforts”.<sup>29</sup> As identified by Devos, “[...] there are two major systems applicable in cases of international insolvency:

1. The principle of the unity of bankruptcy, which means that there is only one competent court to decide on the bankruptcy of the debtor, namely, the court of the country where the debtor has its head or registered office. Under this system it is therefore impossible to initiate separate insolvency proceedings against a domestic branch of a company which has its head office abroad. This principle...is generally linked to another principle, the so-called universality of bankruptcy, meaning that, as far as the debtor’s jurisdiction is concerned, the adjudication of bankruptcy is effective erga omnes in the other countries in which the insolvent debtor may have assets or branches, without there being any need to seek judicial authorisation to have the decision recognised as such, but without prejudice of course to the own conflict of law rules of the foreign jurisdiction concerned (lex fori). In such a system of universality, the bankruptcy law of the country where the insolvency has been initiated in theory governs the conditions and the effects of the bankruptcy, including the ranking of creditors, in respect of all the assets of the insolvent party and all its creditors, subject to the public policy of the other countries.

2. The second major system [...] is the principle of plurality or territoriality of bankruptcy, whereby bankruptcy proceedings are effective only in the country in which they are initiated and proceedings therefore also have to be initiated in every country in which the bankrupt party holds realizable assets. For each estate, courts will apply their own laws as lex fori and will appoint their own liquidator. This territoriality principle leads to the initiation of as many proceedings as there are countries in which assets or branches are located.

There are also systems ‘in between’, often referred to as mitigated universality of bankruptcy, according to which a bankruptcy adjudicated in the country in which, for instance, the debtor’s head office is located should in principle encompass all assets, including assets located abroad, but at the same time courts of these jurisdictions have the right to open separate territorial bankruptcy against branches or even assets of a foreign debtor which are located in this country. In that case, the domestic assets of the foreign bankrupt will be subject to domestic insolvency proceedings with application of domestic bankruptcy law, excluding the recognition of the foreign main insolvency proceedings [...].

These few principles should not be confused or mistaken with the distinction [...] between the single entity and separate entity doctrines, which are partly based on the same ideas as in the

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<sup>29</sup> Included in *International bank insolvencies - a central bank perspective*, M Giovanoli and G Heinrich (eds), 1999, p 311.

above principles but appear to be concerned more with the entitlement of creditors to prove their claims in the various bankruptcies throughout the world.

1. In the single entity approach, banks are wound up as one legal entity, all assets of the bank are encompassed in the liquidation and all worldwide creditors can prove their claims in that proceeding. In that sense the single entity approach resembles the unity and universality principles but the single entity jurisdictions may also include countries in which separate territorial insolvency proceedings may be initiated against branches of foreign banks. As a general rule, claims of creditors of a particular branch would not obtain priority over the claims of creditors of other branches in the liquidation [...].

2. Under the separate entity approach, a domestic branch of a foreign bank is liquidated as if it were a separate bank. All assets of the branch, and also all assets of the foreign bank in the host country are encompassed in the liquidation proceeding, but only creditors of the branch in that host country can prove their claims in the host country proceeding. If the assets of the branch are insufficient, the creditors of that branch might be able to prove their claims in other jurisdictions, subject of course to foreign rules aimed at avoiding double payment of the same claim [...].<sup>30</sup>

A specific issue connected with the separate entity approach and resulting from the possible situation with concurrent insolvency proceedings and different groups of creditors is generally categorised under the so-called principle of equalisation (also referred to as the hotchpot rule). The issue arises when a creditor optimises the satisfaction of its claims by successfully turning to the jurisdiction where the highest return may be obtained and, subsequently, seeks additional dividends in the proceedings of the insolvent institution's home state. "The principle is that a creditor who obtains more in a foreign jurisdiction than he would in the local jurisdiction should be obliged to equalise in the local proceedings by accounting for what he received abroad. Thus if he receives 30 of his claim of 100 abroad, he should not receive any dividends locally until other creditors have received 30 locally."<sup>31</sup>

### **2.3.6 Comity of law**

In view of the problems related to the national nature of insolvency law, the absence of wide-reaching international treaties on insolvency and the possible non-recognition of any extraterritorial effects, courts and judicial authorities have instead relied on a concept referred to as comity of law. This concept means that, in order to overcome the problems raised by cross-border insolvencies, the courts and other judicial authorities in different jurisdictions often cooperate with one another, despite the lack of any applicable international rules. "[C]ommercial necessity has encouraged national courts to provide assistance to each other without waiting for such cooperation to be sanctioned by international convention [...]. It is becoming widely accepted that comity between the courts of different countries requires mutual respect for the territorial integrity of each other's jurisdiction, but that this should not

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<sup>30</sup> Devos op cit, pp 321ff.

<sup>31</sup> Wood, op cit, p 271f.

inhibit a court in one jurisdiction from rendering whatever assistance it properly can to a court in another in respect of assets located or persons resident within the territory of the former.”<sup>32</sup>

### **3. Insolvency proceedings and cross-border aspects**

#### **3.1 Recognition of foreign insolvency proceedings**

The extent to which foreign insolvency proceedings are recognised is a matter for the private international law regime of each country. In the EU member states, the implementation of the new EU insolvency regime, including the Winding-up Directive for credit institutions, will entail the creation of a uniform regime for banks and other entities within the 15 EU member states with explicit and unambiguous rules on jurisdiction and applicable law. This creates the possibility for one insolvency proceeding in one of the member states (the home member state, as defined in the Directive) to be recognised and enforceable throughout the European Union. As against countries outside the European Union, the principles set out in the respective private international laws of the different EU member states can continue to apply, although it can be expected that these will be affected by the implementation of the new EU regime in the respective member state.

As far as recognition of foreign insolvency proceedings in general is concerned (ie apart from recognition within the European Union of such proceedings commenced by competent authorities in one of the EU member states), the respective principles of private international law in each country will apply. The relevant regimes normally provide that recognition can be denied on grounds of public policy or similar considerations, and that recognition is generally afforded when a relevant link between the insolvent entity and the foreign jurisdiction can be construed. This would normally be the case when the entity is resident in, holds substantial assets in or conducts business in the other state under consideration. Recognition may also be conditioned by the requirement that the insolvency proceedings in the foreign state shall not entail consequences that are construed as being unequal or unfair for creditors compared to the treatment they would have received in the home state.

Moreover, in some countries the principle of reciprocity is applied when determining whether a foreign judgment is to be recognised or not. This would make the recognition of foreign insolvency proceedings conditional on the prerequisites for recognition and enforcement being essentially similar (or, in a liberal interpretation, at least not overly divergent) in the foreign jurisdiction in comparison with the rules of the country considering whether to recognise such foreign proceedings. It may also be prescribed that the foreign adjudication must be final and conclusive, and that there must be no concurrent proceedings pending before the courts of the home state, nor any conflict with a judgment already given in that state. Accordingly, the competent authorities in many countries recognise foreign insolvency

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<sup>32</sup> Observed by L J Millet with specific reference to cross-border insolvency in *Credit Suisse Fides Trust S.A. v. Cuoghi* [1997] 3 All E R 724 at 730. See Smart, *Cross-border Insolvency*, p 328.

proceedings and judgments insofar as the rules on recognition in force in the foreign country “mirror” their own rules. Hence, if the countries concerned have sufficiently similar regimes, they may recognise each other’s proceedings and rulings, provided that there are sufficient connections to the country in question and that recognition would not be contrary to public policy or equitable considerations in the recognising state.

### **3.2 Enforceability of financial contracts**

When parties to a contract either expressly document their rights and obligations under certain terms or assume that certain consequences will be implied, any matter which adversely affects or varies the performance or interpretation of the those rights and obligations in accordance with their agreement or implied assumptions will be problematic. Such effects are, however, inherent to the concept of insolvency since the insolvent entity might no longer be in a position to fulfil all its contractual obligations. However, certain contractual arrangements are specifically aimed at protecting the other party exactly from the occurrence of insolvency. These arrangements may provide collateral security in case a party is unable to fulfil the obligations of the contract and are of utmost importance to parties active in the financial markets and, in the end, the stability of the financial system itself. The applicable legal rules should at least entail that the legal framework in which the contract will be executed provides the necessary predictability and certainty in the case of insolvency. Hence, parties should be in a position to determine in advance which countries’ laws will apply to such issues in case of insolvency and what is required under such laws in order to perfect an effective collateral security arrangement. Predictability and legal certainty in this respect will enable an appropriate risk assessment by market participants, which - as we have seen - is an important element regarding promotion of the stability of financial markets. In relation to cross-border insolvency cases this is sometimes not easy to achieve.

In particular, there are a number of specific issues related to financial contracts and collateral security that require attention in the context of insolvency. These issues can prove challenging to address even in a domestic setting and the complexity is even greater in a cross-border situation. In the interests of predictability and stability with regard to transactions carried out in the financial markets, certain provisions of such contracts have received special treatment by the legislator at the level of the European Union and its individual member states. As can be seen from the answers provided by Japan and the United States in response to the contract enforceability survey, there are also special rules with regard to such provisions in these countries. In the following, we consider the protection of collateral in general and of specific collateral security arrangements provided under contract, including contractual netting and set-off and provisions on the valuation of outstanding obligations.

One important issue is the degree to which collateral security rights under a financial contract can be realised in case of insolvency of one of the parties. A lack of legal certainty in this area impedes the effective use of collateral and limits the possible range of transactions of market participants. As regards the law applicable to such arrangements, the *lex rei sitae* principle is generally recognised and usually applied to the effect that the law of the country where the securities are located/registered is applicable. With regard to the law applicable to securities

held through a securities settlement system within the European Union, the Settlement Finality Directive contains rules that create legal certainty in this respect.<sup>33</sup> Pursuant to these provisions, the traditional *lex rei sitae* rule is clarified in relation to book-entry securities in such a way that the law applicable shall be the law of the so-called place of the relevant intermediary (PRIMA). According to the PRIMA principle, the rights of a holder of securities provided as collateral will be governed by the law of the country where the right to the securities collateral is legally recorded on a register, account or centralised deposit system.<sup>34</sup> Through the national implementation of the Settlement Finality Directive, this principle is applicable in all EU countries. This is also reflected in the carve-outs included in the recent EU insolvency legislation, such as the EU Winding-up Directive for credit institutions. The principle of *lex rei sitae*, as applicable with regard to the choice of law applicable to collateral security rights, is generally embraced also by the non-EU countries studied within this project, the United States and Japan.

In addition to certainty with regard to the laws applicable to a specific collateral security arrangement, the rules of those laws have to be sufficiently clear in order to allow parties to structure their transactions accordingly. In general terms, the purpose of collateral taken under financial contracts is to achieve protection from the effects of insolvency, either through the creation of a valid security interest or by an absolute transfer of title arrangement (eg a repurchase agreement). For this to be achieved in the case of repurchase transactions, it is imperative that the applicable legal framework recognises the arrangement as valid and is supportive of netting and set-off. The Collateral Directive provides for a uniform regime for parties as takers of “financial collateral” (as this term will be defined) consisting of transferable securities and cash. The protection of the rights granted under the Collateral Directive is suggested to be extended to collateral security rights irrespective of the purpose or type of underlying transaction, and would be applicable in all the EU member states. Moreover, netting arrangements would be protected under the Collateral Directive, which is also suggested to cover “top-up” collateral, ie additional collateral provided as a result of changes in the market value of collateral given. The Directive also aims to enhance the legal certainty with regard to the enforcement of security rights over collateral through the inclusion of provisions that entitle the collateral taker to realise the collateral without being subject to a waiting period in the event of default of the collateral provider.

In Europe, the choice-of-law aspect of contractual netting and set-off is addressed by the new legal framework that will be in place following implementation of the Winding-up Directive for credit institutions. Pursuant to the carve-outs included in the Directive, netting agreements are not subject to the general rule on applicable law set out in the Directive (ie the law of the home member state of the insolvent entity), but instead to the *lex contractus* of the agreement

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<sup>33</sup> Article 9 (2) of the Settlement Finality Directive.

<sup>34</sup> The current work of the Hague Conference on private international law on a draft convention on the law applicable to dispositions of securities held through indirect holding systems might also be noted in this context. The primary aim of this project is to provide legal certainty with regard to applicable law through the implementation of the PRIMA approach.

containing the netting clause. This exception provides predictability by confirming the agreement on applicable law that the parties have agreed upon when entering into the contract. Within the European Union, therefore, this provision will address the issue and be applicable in any insolvency proceedings taking place. Hence, it should be relatively easy to gauge the validity and enforceability of a netting clause within the jurisdictions of the 15 EU member states since the parties need only assure themselves of the legal rules in their chosen country. The laws of the United States<sup>35</sup> and Japan<sup>36</sup> also generally seem to allow for set-off as far as financial contracts involving credit institutions are concerned.

If *lex contractus* were not to be recognised by the law governing the insolvency proceedings as the law applicable to the netting agreement, this may make it difficult for the parties to assess their situation under the contract, considering that very different netting regimes could potentially become applicable. It is common practice that provisions on the validity of financial netting agreements are laid down in mandatory insolvency law, to the effect that the *lex contractus* does not apply if the contract is governed by the law of another state than the one where the insolvency proceedings take place. Also, setoff provisions are generally included in the insolvency laws of a particular country and have mandatory application.

Further, contractual provisions on the **valuation of outstanding obligations** under financial contracts merit consideration as to whether such provisions would be upheld in view of mandatory rules - in the case of insolvency - whether statutory or based on case law. In the countries studied for this report, the general conclusion seems to be that mandatory valuation parameters on closeout do not exist in statute or case law (in Italy, such provisions exist but market values are used as benchmarks).<sup>37</sup> Parties would therefore seem to be allowed substantial freedom under the laws of these countries to determine the principles of valuation applicable between themselves by way of agreement.<sup>38</sup>

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<sup>35</sup> According to the answers of the United States to the contract enforceability survey, general US law is friendly to setoff, although there are some special cases where this right is limited (eg an issuer of a letter of credit cannot set off against its beneficiary and a lessee cannot set off against its lessor). US insolvency law is also relatively friendly to the *right* of setoff, although setoff is subject to the automatic stay. There are, however, special regimes that remove the stay. These regimes apply in the case of *financial institutions* (ie banks/investment firms) exercising termination rights under certain types of *qualified financial contracts* (ie repos, stock loans and derivatives contracts) and when entering into *netting contracts*. Similar provisions exist for non-financial institutions in the case of *financial contracts* and netting contracts in relation to such contracts. However, the transfer of a failed bank's book to a "bridge bank" would stop a bank or non-bank counterparty from exercising any right of closeout netting.

<sup>36</sup> According to the answers for Japan to the contract enforceability survey, the general law is supportive of setoff. In addition, there are specific legislative provisions that establish protective regimes which support the enforceability of closeout netting for particular types of entity (banks, long-term credit banks and securities firms) and particular types of contract (derivatives, swaps and options). The benefit of these provisions applies provided that at least one of the counterparties is a financial institution (which includes insurance companies).

<sup>37</sup> See the outcome of the contract enforceability survey.

<sup>38</sup> See the outcome of the contract enforceability survey.

### **3.3 Cross-border dimensions of special bank procedures and general insolvency proceedings**

As indicated by the insolvency survey carried out by the Contact Group, countries have chosen different approaches to the treatment of insolvent banks.<sup>39</sup> In some jurisdictions, the insolvency of credit institutions is regulated in the banking laws as a specific subset of insolvency rules, which may be supplemented by general provisions applicable to all insolvency cases in the jurisdiction in question. These special rules on bank insolvency may provide for specific procedures for the declaration of insolvency and the appointment of trustees for the insolvent estate, as well as procedural aspects related to reorganisation measures and the procedural aspects in general. In other jurisdictions, this is not the case and, accordingly, the general insolvency regime also applies to banks and financial institutions, although there may be some specific provisions derived from case law on certain limited aspects of bank insolvency.

Whilst both of these approaches may function well in relation to domestic insolvency cases, problems can arise in international insolvency cases concerning large financial institutions where concurrent insolvency procedures may be commenced in more than one country. For instance, a more tailor-made arrangement for banks may be better suited to facilitate rescue efforts and the reorganisation of the entity to the benefit of financial stability. On the other hand, an applicable general insolvency regime in another jurisdiction may not give the same powers to the liquidator or administrator to save, for example, a subsidiary located in that country. If these regimes cannot be reconciled with one another on a specific matter during the course of the proceedings, conflicts may occur. In the absence of an international insolvency regime addressing these types of conflicts, the problems arising are generally solved through cooperation between the authorities involved on a pragmatic basis. However, such ad hoc solutions may not be sufficient in all cases where there exist two or more distinctly different legal regimes applicable on a concurrent basis, particularly when such differences refer to more fundamental aspects of the insolvency procedure.

### **3.4 Cross-border dimensions of liquidation and reorganisation**

One fundamental question at the outset of major insolvency cases is whether a rescue attempt should be undertaken through reorganisation measures. Similar considerations as for the distinction between special bank procedures and general insolvency proceedings arise with regard to the cross-border dimensions of the choice between a rescue effort and reorganisation, on the one hand, and liquidation, on the other. Again, different countries may have different types of reorganisation measures, as well as different rules and criteria for the situations where a reorganisation of the insolvent entity may be attempted, which in a cross-border insolvency case can create some obvious problems of inconsistencies. It might therefore be the case that proceedings taking place concurrently in different jurisdictions with different insolvency laws, where one party's proceedings are not recognised by the other,

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<sup>39</sup> See the outcome of the insolvency survey.



could lead to contrary conclusions as to whether reorganisation or liquidation should be conducted.

One specific issue is whether the trustee of the insolvent entity or its assets in one jurisdiction will recognise a decision in a concurrent proceeding elsewhere which may be part of or lead to the survival of the entity concerned. It is not certain that the proceedings in one country will be stayed in order to await the outcome of the adjudication of an issue better dealt with in another country. In particular, a decision to impose a moratorium on the enforcement of creditors' claims vis-à-vis the insolvent entity in favour of a rescue effort may not be accepted in the concurrent proceedings. In addition, the rules on judicial compositions, whereby creditors will be required to accept only a certain percentage of their respective claims as dividends in the process, may differ between the countries and could lead to conflicts.<sup>40</sup> Again, today's solution to this potential problem area can be found under the concept of informal cooperation and coordination between the authorities involved referred to as comity of law. "In the context of multi-jurisdictional insolvencies the courts of different jurisdictions should strive - to the extent that they can within the parameters of their own fundamental precepts of justice - to ensure that matters are adjudicated in the proper forum with the closest connection to the subject-matter. Principles of international comity [...] provide the touchstones to assist them in doing so [...]."<sup>41</sup>

## **4. Legal regimes for cross-border insolvency**

In this chapter, we make use of the European legislative experience with regard to cross-border insolvency issues in order to consider how such issues can be addressed (with particular focus on the new EU Directive on insolvency procedures for credit institutions). In addition, this chapter also indicates how these questions are addressed in some national jurisdictions represented within the Contact Group (Italy, the Netherlands, the United Kingdom and the United States).

### **4.1 European Union**

#### ***4.1.1 The EU legal acts and the underlying principles***

The underlying principles of the new EU legislation in the field of cross-border insolvency are unity and universality.<sup>42</sup> The aim has been to implement these general principles in relation to EU member states, and each legal act that has been adopted reflects this intention. These are a

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<sup>40</sup> For country specific examples, see Wood, *op cit*, p 179.

<sup>41</sup> J Blair in *Re Olympia and York Developments Ltd* (1996) 29 O R (3d) 626, at 633. See Smart, *op cit*, p 331.

<sup>42</sup> UNCITRAL offers no universal approach since host country authorities may decide whether they will grant "exequatur". The approach of the EU regulation, however, could be qualified as "modified universalist" since secondary proceedings are allowed; "full universality" would exist under the two Directives relative to insurance undertakings and credit institutions.

regulation on insolvency proceedings and two directives providing specific rules concerning the winding-up and reorganisation of insurance undertakings and of credit institutions, respectively:

1. Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings<sup>43</sup> (the Insolvency Regulation);
2. Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings<sup>44</sup> (the Winding-up Directive for insurance undertakings);
3. Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding-up of credit institutions<sup>45</sup> (the Winding-up Directive for credit institutions).

The introduction of the principles of unity and universality has resulted in a legal framework for cross-border insolvency cases within the European Union under which a single set of insolvency rules can apply to the enforcement of all creditors' claims, and decisions of the competent authority have universal application. The Insolvency Regulation and the two Directives do not seek to harmonise national legislation concerning reorganisation measures and winding-up proceedings, rather they ensure mutual recognition and coordination of these procedures by member states. The principles of home country control, minimum harmonisation and mutual recognition - forming the core of the market integration principles for financial markets - have also been transposed in the field of insolvency procedures and constitute the basis of the Winding-up Directive for insurance undertakings and the Winding-up Directive for credit institutions. In particular, the home country and mutual recognition principles - being introduced by the First and Second Banking Co-ordination Directives,<sup>46</sup> respectively - are extended to the insolvency of credit institutions.

The Insolvency Regulation will be effective and directly applicable in EU member states on 31 May 2002 without any additional national legislative measures.<sup>47</sup> The two Winding-up Directives, on the other hand, need to be implemented in the national legal systems within specified time frames - by 20 April 2003 in the case of the Winding-up Directive for insurance undertakings and by 5 May 2004 in the case of the Winding-up Directive for credit institutions.

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<sup>43</sup> OJ L 160, 30.6.2000, p 1.

<sup>44</sup> OJ L 110, 20.4.2001, p 28.

<sup>45</sup> OJ L 125, 5.5.2001, p 15.

<sup>46</sup> First Banking Co-ordination Directive 77/780/EEC, OJ L 322/30 of 17.12.1977; Second Banking Co-ordination Directive 89/646/EEC, OJ L 386/1 of 30.12.1989; now replaced by Directive 2000/12/EC relating to the taking-up and pursuit of the business of credit institutions, OJ L 126/1 of 16.5.2000.

<sup>47</sup> As regards the application of the Insolvency Regulation, it should be noted that the Regulation is based on title IV of the EC Treaty, which does not apply to the United Kingdom, Ireland and Denmark. However, the UK and Ireland made use of their selective opt-in with regard to title IV under a specific protocol to the Amsterdam Treaty and so the Regulation applies to them as well. Denmark has no selective opt-in and, hence, the Regulation does not apply to Denmark.

The main objective of the Insolvency Regulation is to ensure that cross-border insolvency proceedings operate efficiently and effectively within the European Union. Another objective is to avoid incentives for parties to transfer assets from one member state to another and/or to choose the jurisdiction in which to initiate insolvency proceedings in order to obtain the most favourable legal position (“forum shopping”).<sup>48</sup> Insolvency proceedings within the meaning of the Insolvency Regulation are defined as “collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator.”<sup>49</sup> The Insolvency Regulation replaces a number of existing bilateral conventions.<sup>50</sup> Its scope is wide, although limited in that insolvency proceedings concerning insurance undertakings, credit institutions, investment undertakings holding funds or securities for third parties and collective investment undertakings are expressly excluded. Credit institutions and insurance undertakings are instead subject to the two sectoral Winding-up Directives, taking into account that national supervisory authorities may have wide-ranging powers of investigation in relation to such entities. The Insolvency Regulation addresses jurisdiction, recognition and applicable law, and also contains specific conflict-of-laws provisions. It provides that the courts of the member state where the centre of a debtor’s main interest is situated shall have jurisdiction to open insolvency proceedings.<sup>51</sup> The law applicable to insolvency proceedings shall be the law of this member state. The insolvency proceedings shall be recognised in all other member states.<sup>52</sup> The Regulation also provides for the possibility under certain circumstances to open secondary insolvency proceedings.<sup>53</sup> It subjects, *inter alia*, the bankrupt estate and the claims of creditors, as well as the right of set-off, to the law of the state of the opening of proceedings. However, the right of set-off shall not be affected by the insolvency proceedings, except under rules for voidability, voidness and non-enforceability.<sup>54</sup>

The regime under the Winding-up Directive for insurance undertakings will apply to reorganisation measures and winding-up proceedings with regard to insurance companies. The Directive also applies to reorganisation measures and winding-up proceedings concerning branches of insurance undertakings within the European Union, including branches of such undertakings having their head office outside the European Union. In the case that an insurance undertaking with branches in other EU member states becomes insolvent, the entity

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<sup>48</sup> “Forum shopping” may also entail the choice of law applicable to a legal entity (*lex corporacionis*) taking into account the applicable insolvency rules. In this sense, forum shopping may be more relevant for common law jurisdictions that follow the “incorporation doctrine” and less of a problem for the civil law jurisdictions applying the “seat doctrine”. This holds true at least when the application of the “seat doctrine” requires a “reality test” for the determination of the legal entity’s seat (eg the presence of the head office for management purposes).

<sup>49</sup> Article 1.1 of the Insolvency Regulation.

<sup>50</sup> Article 44 of the Insolvency Regulation.

<sup>51</sup> Article 3.1 of the Insolvency Regulation.

<sup>52</sup> See Chapter II of the Insolvency Regulation.

<sup>53</sup> See Chapter III of the Insolvency Regulation.

<sup>54</sup> Article 6 of the Insolvency Regulation.

will be subject to a single insolvency proceeding in the member state where it has its registered office (the home member state). These proceedings will be governed by a single insolvency regime, namely the laws of the home member state. This approach is consistent with the home country control principle, which constitutes one of the pillars of EU financial law. Coordinated rules for reorganisation measures are intended to enable the preservation or restoration of the financial soundness of an insurance undertaking and to prevent to the extent possible a winding-up situation. The structure of the Winding-up Directive for insurance undertakings is similar to that of the Winding-up Directive for credit institutions. Accordingly, the Directive reflects an approach based on mutual recognition, and the interrelated principles of unity, universality, coordination, publicity, equivalent treatment and protection of insurance creditors. It also contains some specific provisions of particular relevance in the context of insurance activities.

The Winding-up Directive for credit institutions applies to such entities and to their branches set up in member states other than those in which they have their head offices. It takes into particular consideration the situation of credit institutions which run into difficulties and which have branches in other member states. In such cases, there is a recognised need to maintain the unity between the credit institution and its branches. The main rules and provisions of this Directive are afforded some further specific consideration in 4.1.2 below.

An additional EU legal act of relevance to certain aspects of cross-border insolvency is the Settlement Finality Directive, which is already in force and which contains certain provisions on applicable law and the protection from the effects of insolvency in relation to payment and securities settlement systems. The Settlement Finality Directive provides that insolvency proceedings should not have retroactive effect with regard to the rights and obligations of participants in a system.<sup>55</sup> It also determines the law applicable to rights and obligations vis-à-vis a participant in a system in the event of insolvency proceedings against such participant as the law governing the system.<sup>56</sup> In addition, Article 9 provides the conditions under which collateral security is protected from the effects of the insolvency laws that might otherwise apply. The protection from the effects of insolvency applies to the rights of EU central banks and the ECB in relation to collateral security provided to them and to the rights of a participant to collateral security provided to it in connection with a payment or securities settlement system.<sup>57</sup> Moreover, the law applicable to the transfer of rights to book-entry securities, as specified in the Directive, shall be the law of the member state where the register or record of such rights is held.<sup>58</sup> In this connection, it should be noted that the Insolvency Regulation provides that special provisions of the Settlement Finality Directive take precedence over the general rules contained in it.<sup>59</sup> Moreover, the Winding-up Directive for

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<sup>55</sup> Article 7 of the Settlement Finality Directive.

<sup>56</sup> Article 8 of the Settlement Finality Directive.

<sup>57</sup> Article 9 (1) of the Settlement Finality Directive.

<sup>58</sup> Article 9 (2) of the Settlement Finality Directive.

<sup>59</sup> See Recital 27 and Article 9 of the EU Insolvency Regulation.

credit institutions expressly refers to the Settlement Finality Directive. In doing so, the principle is confirmed that insolvency proceedings must not have any effect on the enforceability of orders validly entered into payment or securities settlement systems, or on collateral provided for a system.<sup>60</sup>

#### ***4.1.2 The Winding-up Directive for credit institutions***

The rules on the cross-border aspects of insolvency proceedings contained in the Winding-up Directive for credit institutions are mainly of a private international law character, designating the country which shall have jurisdiction in the event of a credit institution becoming insolvent in one of the EU member states. The member state in which the insolvent credit institution has been authorised to carry out its business (the home member state) shall be the country thus designated and its authorities shall be competent to initiate insolvency proceedings. The competent authorities of the home member state are vested with exclusive authority to decide and implement reorganisation measures or liquidation procedures against the registered offices of a bank. This applies also to proceedings against branches in other member states (host member states).<sup>61</sup>

The conflict-of-law provisions of the Winding-up Directive for credit institutions form a central part of the Directive in that they lay down an EU-wide uniform regime with regard to the applicable laws in cross-border insolvency proceedings (as a rule, the laws of the home member state). Moreover, the Directive also contains rules of a procedural nature on cooperation between judicial authorities in different countries as well as some rules of a more substantive nature. Thus, when the Directive has been fully implemented, there will be only one EU-wide procedure for each insolvent credit institution that should ensure equal treatment for all creditors of any one insolvent EU credit institution.

The laws of the home member state govern, in particular, the conditions for invoking set-off, the effects of insolvency on contracts, the treatment of claims and rules on assessing the admission and priority of claims, and the rights of creditors which have obtained partial satisfaction after the opening of insolvency proceedings by virtue of a right in rem or through a set-off.<sup>62</sup>

In order to provide for clarity and transparency in the insolvency proceedings, the authorities in the home member state need to inform the authorities of host member states without delay of a decision to open winding-up or reorganisation proceedings. If possible, such notification should take place before the decision to commence proceedings is taken.<sup>63</sup> The provisions of the Directive on the right for creditors to lodge claims provide that creditors shall be treated equally and be subject to the same rules on ranking of claims, regardless of whether they have

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<sup>60</sup> See Recitals 25 and 26 of the Winding-up Directive for credit institutions.

<sup>61</sup> Article 9 (1) of the Winding-up Directive for credit institutions.

<sup>62</sup> Article 10 of the Winding-up Directive for credit institutions.

<sup>63</sup> Article 9 (2) of the Winding-up Directive for credit institutions.

their domicile in the home member state or in another member state.<sup>64</sup> There are also provisions applicable to the situation where winding-up proceedings are initiated against an EU branch of a credit institution the head office of which is located outside the European Community. In such situations, the authorities of the member state where the proceedings are opened shall inform the competent authorities of other member states in which the affected credit institution has set up branches of the decision to initiate proceedings against such an EU branch.<sup>65</sup>

#### ***4.1.3 The carve-outs under the Winding-up Directive for credit institutions***

Legal certainty in the context of cross-border insolvency proceedings is enhanced by clear and uniform rules on the law applicable to such proceedings, such as the choice-of-law rules laid down in the Winding-up Directive for credit institutions. However, there are instances where exclusive reliance on the laws of the home member state may be detrimental to the stability and functioning of the financial markets. In order to take this concern into account, the Directive sets out a number of situations where the general principle of the application of the laws of the home member state<sup>66</sup> shall not apply. Consequently, other rules contained in the Directive determine the law that shall apply to a number of specific situations identified in the Directive (the so-called ‘carve-outs’). Some of these exceptions are of great importance to the functioning of financial markets and are described below:

1. The rights in rem of creditors or third parties in respect of tangible or intangible, movable or immovable assets belonging to the affected credit institution which are situated within the territory of another member state shall not be affected.<sup>67</sup> Enforcement of proprietary rights in financial instruments which presupposes the recording thereof in a register, account or central deposit system shall be governed by the law of the country where the relevant register is maintained. This principle (the place of the relevant intermediary (PRIMA) principle) is also contained in Article 9(2) of the Settlement Finality Directive.
2. The rights of creditors to set off their claims against the claims of the insolvent credit institution shall be determined by the law applicable to the credit institution’s claim.<sup>68</sup>
3. Netting agreements shall be governed solely by the law of the contract which governs such agreements.<sup>69</sup> The same principle applies to repurchase agreements.<sup>70</sup>
4. Without prejudice to the PRIMA principle, transactions carried out on regulated markets shall be governed solely by the law of the contract which governs such transactions.<sup>71</sup>

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<sup>64</sup> Article 16 of the Winding-up Directive for credit institutions.

<sup>65</sup> Article 19 of the Winding-up Directive for credit institutions.

<sup>66</sup> Article 10 of the Winding-up Directive for credit institutions.

<sup>67</sup> Article 21 of the Winding-up Directive for credit institutions.

<sup>68</sup> Article 23 of the Winding-up Directive for credit institutions.

<sup>69</sup> Article 25 of the Winding-up Directive for credit institutions.

<sup>70</sup> Article 26 of the Winding-up Directive for credit institutions.

#### **4.1.4 *The EU insolvency regime in an international context***

The EU legislation on cross-border insolvency issues primarily relies on the effectiveness of mutual recognition. Furthermore, it provides a harmonised legal framework and legal certainty within the European Union with regard to the country where insolvency proceedings may be commenced and the law applicable to such proceedings. Moreover, the carve-outs explicitly identified in the Directive counteract the risk inherent in the application of one categorical and inflexible principle regarding the choice of law. The exceptions to the applicability of the home country laws seem to increase legal certainty as regards certain specific activities of crucial importance to the international financial markets such as contractual netting and set-off. The implementation of the unity principle with regard to insolvency proceedings involving EU branches of non-EU entities would, furthermore, enhance predictability and legal certainty for non-EU, as well as EU, creditors of such financial institutions that may be affected by this rule.

The drafting process leading up to the adoption of this regime took place over a long period of time and included much reflection on these issues by the various parties involved. This experience and the outcome of this difficult venture may very well prove to be useful to other regional or international projects on insolvency law reform. On the other hand, substantive rules of insolvency law remain mainly national in nature, including in EU member states, and we will therefore also briefly consider the treatment of cross-border insolvency aspects in some national legal systems.

## **4.2 Italy**

### **4.2.1 *Insolvency law in general***

Italian law lays down special rules with regard to financial crises and insolvency procedures for financial institutions. The crisis procedures for financial institutions are to a large extent governed by Legislative Decree 385 of 1 September 1993 (the Banking Law). As regards aspects of insolvency and financial crisis procedures that are not covered by the Banking Law, it is explicitly stated in Article 80(6) of this Law that its provisions shall apply insofar as they are appropriate. The insolvency proceedings applicable to investment firms are laid down in Articles 56 and 57 of Legislative Decree 58 of 24 February 1998 (the Financial Law).

The authority competent to commence proceedings under the Banking Law is the supervisory authority.<sup>72</sup> In this regard, such proceedings differ from the insolvency procedures under the Royal Decree Law 267 of 16 March 1942 (the Bankruptcy Law),<sup>73</sup> where the ordinary judicial

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<sup>71</sup> Article 27 of the Winding-up directive for credit institutions.

<sup>72</sup> The supervisory authorities for banks are the Interministerial Committee for Credit and Savings, the Minister of the Treasury and the Bank of Italy.

<sup>73</sup> The following legal instruments are of relevance in the context of Italian insolvency proceedings:

Royal Decree Law No 267 of 16 March 1942: Articles 1-159 concerning the bankruptcy of commercial entrepreneurs and of commercial companies; Articles 160-86 on the technique of composition with creditors

authorities are vested with the competence to handle the proceedings. The competent authority to initiate proceedings pursuant to the Financial Law is the relevant supervisory authority.<sup>74</sup>

#### **4.2.2 National treatment of cross-border insolvency issues**

At present, Article 9 of the Bankruptcy Law recognises the Italian jurisdiction as competent to issue an insolvency order in respect of a foreign firm, even if a similar judgment has already been issued abroad. In practice, Italian judges tend to use this power only if the foreign firm has an office in Italy but, according to some of the legal literature, the presence of assets in Italy would be sufficient. The Italian authorities can decide in favour of administration with regard to the branches of a non-EU bank (Article 77 of the Banking Law). They can also apply compulsory administrative liquidation to branches of EU banks and financial firms (where the home country authorities have revoked the authorisation) and to non-EU banks and financial firms (Article 95 of the Banking Law and Article 58 of the Financial Law). According to Law 218 of 31 May 1995, the recognition of foreign judgments no longer requires a special procedure if a number of conditions, mostly regarding procedural guarantees, are satisfied.<sup>75</sup>

#### **4.2.3 Insolvency law reform**

A recent draft law, No 970, containing the proposal to delegate to the government the management of the reform, was presented to the Italian Parliament on 21 June 2001. This proposal obliges the government to legislate, through a Legislative Decree, in order to introduce changes in a number of areas relative to insolvency proceedings. The stated objective of the reforms to be implemented is to enhance the possibility of saving companies in distress through reorganisation procedures. In order to do this, there will be two different phases in the proceedings against companies in financial distress. During the first, preparatory, period, the stated goal is to allow the company to continue its operations by way of reorganisation measures. Failing this, the second phase of the procedure will entail

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(‘Concordato Preventivo’); Articles 187-93 on temporary receivership; Articles 194-215 on compulsory administrative liquidation; final provisions regarding criminal issues related to bankruptcy.

Legislative Decree No 270 of 8 July 1999, introducing new provisions concerning the extraordinary administration of large enterprises in crisis (‘Amministrazione straordinaria delle grandi imprese in crisi’).

Legislative Decree No 385 of 1 September 1993 (Banking Law): Articles 70-9 on the extraordinary administration of banks; Articles 6-*quater* on compulsory administrative liquidation of banks; Article 97 on voluntary liquidation.

Legislative Decree No 58 of 24 February 1998 (Financial Law): Article 56 on extraordinary administration for SIM (Società di Intermediazione Mobiliare), Società di Gestione del Risparmio and SICAV (Società di Investimento a Capitale Variabile); Article 57 on compulsory administrative liquidation for SIM (Società di Intermediazione Mobiliare), Società di Gestione del Risparmio and SICAV (Società di Investimento a Capitale Variabile).

<sup>74</sup> The supervisory authorities for investment firms are the Bank of Italy, the Minister of the Treasury and CONSOB.

<sup>75</sup> Article 64 of Law No 218 of 31 May 1995.



insolvency proceedings. During the preparatory period, the debtor is not excluded from the management of the company and can thus, inter alia, negotiate reorganisation measures with individual creditors or all creditors in order for a reconstruction proposal to be presented to the competent authorities. The duration of the preparatory period for insolvency proceedings under the envisaged new legislation will be limited to two years. Some changes will also be introduced that have a bearing on the second phase of the procedure. In particular, the debtor will only lose its legal capacity insofar as it is not required to be retained in the interest of effecting a recovery of the enterprise. Furthermore, the duration of the suspect periods laid down in Italian law is reduced by half, with the express intention of promoting legal certainty for counterparties of the debtor.

### **4.3 Netherlands**

#### ***4.3.1 Insolvency law in general***

The basis of the insolvency law of the Netherlands is found in the Law on Insolvency of 1893, as amended.<sup>76</sup> Several other laws contain further provisions or refer to the Law on Insolvency, but not all of these are relevant to this report. The Law on Insolvency provides the general basis for bankruptcy and protection from creditors. In this law there are extensive provisions on the declaration of insolvency, its consequences, the liquidator and composition. The scope of the Law is broad and the sections principally of a procedural nature. In addition, the Dutch Civil Code<sup>77</sup> contains a few references to insolvency, one example being Article 2:248 BW which defines the liability of directors of a limited liability legal person.

The Act on the Supervision of the Credit System 1992<sup>78</sup> is the basis for Dutch rules and regulations concerning credit institutions. In this Law reference is made to the Law on Insolvency, for example in Article 71 Wtk concerning finality of payment. A declaration of insolvency has implications that follow from the Act on the Supervision of the Credit System 1992, albeit more with regard to matters related to licensing and supervisory aspects, and not in such a manner that rights or obligations are created.

Finally, the Act on the Supervision of Securities Trading 1995<sup>79</sup> is the basis for Dutch rules and regulations concerning securities trading. A declaration of insolvency has implications that follow from the Act on the Supervision of Securities Trading 1995, albeit more in a licensing and supervisory sense, and not such that rights or obligations are created.

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<sup>76</sup> Wet van 30 September 1893, Stb. 140, op het faillissement en de surséance van betaling, zoals die wet nader is gewijzigd.

<sup>77</sup> Burgerlijk Wetboek.

<sup>78</sup> Wet toezicht kredietwezen 1992.

<sup>79</sup> Wet toezicht effectenverkeer 1995.

### **4.3.2 National treatment of cross-border insolvency issues**

The Law on Insolvency of 1893, in Title 1, Chapter 10, refers to international law aspects. Articles 203-205 state the obligation of creditors to reimburse the estate for assets they have independently seized outside the Netherlands. Legal doctrine in the Netherlands adheres to the principle of territoriality, according to which an insolvency only has effect in the country in which it is declared. In order to claim assets in other countries the creditor or liquidator would have to obtain a new executory title for each jurisdiction in which he wishes to claim assets.

The High Court of the Netherlands has considered the issue on two occasions. In its decision of 15 April 1955<sup>80</sup> the High Court considered that although the Dutch State, due to limitations of sovereignty, is not empowered to grant enforceability outside the Netherlands to a declaration of insolvency in the Netherlands, assets located outside the Netherlands that have come into the possession of the liquidator may be included in the insolvency estate. Conversely, in its decision of 2 June 1967<sup>81</sup> the High Court of the Netherlands considered that although a liquidator in a French insolvency may claim assets situated in the Netherlands, assets located in the Netherlands are not part of the insolvency estate as such. In practice this means that such assets may be seized and that the debtor may be declared insolvent again - for the assets situated in the Netherlands on this occasion.

### **4.3.3 Insolvency law reform**

In anticipation of international developments in this field, a report has been prepared by a government working group of insolvency specialists on how the insolvency regime in the Netherlands can be modernised. Although not available at the time of preparation of this report, it is expected that this report will be published shortly and that it may contain some references to developments as regards cross-border insolvency, particularly in view of the new EU regime, which may affect Dutch private international law.

## **4.4 United Kingdom**

### **4.4.1 Insolvency law in general**

There are three main legal systems in the United Kingdom, those of England and Wales, Scotland and Northern Ireland. The following text applies to England and Wales. Under current English law, insolvency proceedings are predominantly regulated by the Insolvency Act 1986 (the Act). There are essentially four types of insolvency procedure in England: liquidation, receivership, administration and voluntary arrangement.

Liquidation (or winding-up) brings a company's existence to an end (dissolution). The liquidation process consists of the gathering of the company's assets, the determination of its liabilities, and the distribution of its assets amongst its creditors. Liquidation can be in the form of a compulsory winding-up order by a court (commenced by petition of a creditor), or a

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<sup>80</sup> *Comfin* [1995] NJ, 542.

<sup>81</sup> *Hiret-Chiotakis* [1968] NJ, 16.

voluntary winding-up either by the company's members or by its creditors. Technically speaking, voluntary liquidation should not involve any insolvency. The priority of payment on a liquidation is: (i) secured creditors with a fixed charge; (ii) liquidator and other professional costs of liquidation; (iii) preferential creditors (eg customs, inland revenue, certain employee rights); (iv) secured creditors with a floating charge; (v) unsecured creditors; and (vi) members.

Under a receivership, an "administrative receiver" is appointed over the whole or substantially the whole of a company's property under a security, and specifically a floating charge (section 29 of the Act). Although an administrative receiver has general duties, his primary obligation is to enforce and realise the secured asset.

Administration is essentially a rescue procedure introduced by the Act to promote the possibility of preserving the business and is therefore usually commenced by the company. The Court appoints an administrator, who has wide powers to attempt to trade through the problem and maintain the company as a going concern. Amongst the tools in the administrator's possession are protection from liquidation or receivership proceedings.

A voluntary arrangement and a scheme of arrangement are essentially forms of compromise amongst a company's creditors whereby 75% (for a voluntary arrangement) of creditors (in value of debts) can bring about a moratorium on other creditor action whilst the arrangement is in place.

Apart from insurance companies, which have their own insolvency regime, banks and financial institutions are essentially subject to the aforesaid. In addition, the Financial Services Authority (FSA) is empowered<sup>82</sup> to present a petition for winding-up of an authorised bank or financial institution on the grounds either of inability to pay its debts as they fall due (as defined), or that it is just and equitable.

#### ***4.4.2 National treatment of cross-border insolvency issues***

Under English law, any winding-up proceedings conducted against a bank in the United Kingdom are in theory applicable in relation to the company as a whole, ie as an indivisible entity including all its branches. There is no discriminatory treatment of foreign creditors: all creditors, worldwide, of such a bank would be entitled to claim their rights in the insolvency proceedings, creditors resident in the United Kingdom would not be given any priority or preferential treatment over the claims of non-resident creditors.

The scope and enforcement of English insolvency proceedings outside the United Kingdom are necessarily conditioned by the need for cooperation and consent of non-English court in order to take effect. English courts may wind up foreign companies, ie those not registered under the Companies Act 1985 but incorporated under a foreign jurisdiction. Although in theory universal, the courts would in practice exercise such jurisdiction only where there were assets of the company in the United Kingdom, the company carried on business in the United Kingdom, or benefit might reasonably be expected to accrue to creditors of the company from

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<sup>82</sup> Under section 367 of the Financial Services and Markets Act 2000.

the making of a winding-up order in the United Kingdom. If the company was already in liquidation in its home country, the English proceedings would be subsidiary to such proceedings, sending details of assets and claims to the relevant competent authorities and aiming principally to realise the UK assets of the company and deal with creditors which had lodged claims in the United Kingdom. Recent case law from the BCCI affair<sup>83</sup> suggests that the courts will apply the provisions of English law to such proceedings, even where the effects of doing so mean a different outcome from the potential results of applying the relevant provisions of foreign law.

Foreign liquidation proceedings may be recognised in the United Kingdom in a number of instances, namely where the winding-up is conducted under, or recognised by, the law of the place where the company is incorporated; where the company has submitted to the jurisdiction of a foreign court; or, where the company carried on business in a foreign jurisdiction. Such recognition, however, may be conditional on the requirement that such grant of recognition would not be contrary to public policy, constitute fraud, or entail an attempt to enforce foreign penal or revenue law through foreign proceedings. Furthermore, there is a general principle in English law that the courts do not generally recognise foreign proceedings where they result in an outcome creating a material difference in the treatment of creditors as opposed to the potential outcome of such proceedings under English law.

#### **4.4.3 *Insolvency law reform***

The Insolvency Act 2000 offered a new rescue procedure, in the form of a voluntary arrangement, for small companies. Further and more major insolvency law reform was set out in a white paper in July 2001. The stated aims of the reform are to create a fairer corporate insolvency system in which there is a duty of care to all creditors. It achieves this by abolishing, in nearly all cases, the right of a secured creditor to appoint an administrative receiver. Instead, it is proposed that administration will take its place and be revamped as a new “collective procedure” intended to provide the opportunity for all creditors to participate, and where the administrators will owe a duty to both secured and unsecured creditors. In a radical change therefore, banks and other secured creditors would lose their pre-eminent security enforcement rights. Although this loss is to a certain extent mitigated by the introduction of various other measures, such as abolishment of crown preference in all insolvency proceedings, and the widening of the scope of an administration order so that it could be made to include the realisation of security held by a floating charge holder, the bill would appear to weaken the position of secured creditors - although it appears that it will not apply to agreements made prior to the date the bill comes into force. Following the completion of the consultation period in November 2001, it remains to be seen what changes will be incorporated before the bill is taken forward in the next Parliamentary session.<sup>84</sup>

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<sup>83</sup> Re BCCI (No. 10) [1997] Ch 213; [1997] 2WLR 172; [1996] 4 All ER 796.

<sup>84</sup> *Felixstowe Dock and Railway Co. v. United States Lines Inc.* [1989] QB 360; [1989] WLR 109; [1988] 2 All ER 77; see also Neil Cooper and Rebecca Jarvis, *Recognition and enforcement of cross-border insolvency - a guide to international practice* (1995), p 34.

## **4.5 United States**

### ***4.5.1 Insolvency law in general***

The United States has several systems of insolvency law. The Bankruptcy Code (“Code”) is the broadest in scope. The Code regulates the liquidation and reorganisation of most business entities and natural persons. It contains several liquidation schemes, including a general scheme applicable to natural persons and most entities. It also contains specialised liquidation schemes for securities firms, commodities merchants and a very few specialised banks. The Code contains several reorganisation schemes: a general scheme (Chapter 11) and specialised schemes for natural persons, small businesses, municipalities and family farmers. Generally, the debtor may choose between liquidation and reorganisation, and often convert one to the other at will. However, municipalities and railroads can only use reorganisations; liquidations are mandatory for securities firms and commodities merchants. Creditor-initiated bankruptcies are possible under the Code, but are very rare. However, creditor rights outside bankruptcy are very strong (especially for secured transactions), and encourage distressed debtors to file. Excluded from the Code are almost all insurers and banks that do business in the United States.

The Code was initially enacted in 1898, replacing a patchwork of state law. The Code is federal law, but draws on state law for the underlying property and contractual rights affected by the bankruptcy proceeding. The Chapter 11-style reorganisation was introduced in the 1938 Chandler Act, an amendment to the Code. The Code was reorganised and revised in 1978, and has been amended every few years since then. Many of the amendments have concerned financial firms or financial contracts.

Bank insolvency law is structurally complex. It is rooted in the law of the chartering jurisdiction (or licensing jurisdiction, for foreign banks). This jurisdiction is federal for national banks, and at the state level for state banks. This law may be traced to the 1830s or so, but most of it has been pre-empted and modernised by the Federal Deposit Insurance Act. Therefore, bank insolvency law is reasonably consistent throughout the United States, at least for insured banks. However, some state variations remain. Few branches of foreign banks are insured, but their insolvency law has generally been modernised since the BCCI insolvency.

### ***4.5.2 National treatment of cross-border insolvency issues***

The Bankruptcy Code and bank insolvency law are similar for United States persons, but treat foreign persons very differently. (“Person” includes both natural individuals and entities.) For US persons, both regimes are universalistic. In other words, they treat foreign private claims identically to US private claims. (In the Code, US tax claims receive a priority.) The Code and bank insolvency law define US persons differently. In bank insolvency law, a US person is chartered by a US jurisdiction. In the Code, a US person may include any person doing business or with assets in the United States. The Code contains an explicit “hotchpot” rule, requiring creditors who wish to share in the Code distribution to turn any foreign collection to the bankruptcy proceeding. Bank insolvency law contains no such explicit rule.

For foreign persons, the Code and bank insolvency law diverge. In the 1970s, the Code adopted Section 304, creating an ancillary proceeding for persons in foreign insolvency proceedings. (This was largely in response to international bank failures of this time, eg Bankhaus Herstatt and Israel-British Bank.) Section 304 preserves the option of an independent local bankruptcy. However, courts seldom choose this option, unless either: 1) the foreign liquidator so desires or 2) the foreign insolvency does not comport with minimal notions of comity. Although comity is a case by case determination, US courts have been very respectful to foreign liquidators. For most jurisdictions, an ancillary proceeding is predictable.

Bank insolvency law is very different. US branches of foreign banks are liquidated separately from the bank. For banks with only state-licensed branches, each state acts as a sovereign. For such banks, only creditors of the US branch (who may be nationals of any country) receive in the distribution. Any excess first covers shortfalls in other state proceedings, and then goes to the home-country proceeding. If a bank has at least one nationally licensed branch, the liquidation is national, with creditors of US branches treated equally, and excess going to the home country proceeding. The liquidation asserts jurisdiction over all bank assets present in the jurisdiction, or booked in the jurisdiction.

#### ***4.5.3 Insolvency law reform***

US insolvency law is the object of constant statutory tinkering, especially at the federal level. Many recent reforms have tended to reduce systemic risk in the financial system, eg the extension of closeout netting to new institutions and new contracts, the increased availability of accelerated liquidation procedures to more financial firms, and non-insolvency law clarifying the holding and pledge of securities. Most of the judicial decisions have been consistent with this trend, especially those regarding closeout of securities contracts.

Pending bankruptcy legislation may transform the law of personal bankruptcy and affect several aspects of business insolvency. Two of the pending business insolvency reforms are particularly significant. The pending legislation would adopt the UNCITRAL Cross-border Model Insolvency Law (which is very similar to current US ancillary proceedings). It would also increase the scope of cross-product derivatives netting. The future of this legislation is uncertain.

## **5. The legal and institutional underpinning of cross-border insolvency**

As we have seen, many of the issues arising in the area of cross-border insolvency stem from the lack of an international legal and institutional framework addressing potential problems and discrepancies between countries on an international level. There are few or no international rules with legal force on the topic. For instance, there are no truly international insolvency treaties, and to the extent that rules exist they do not address the cross-border dimension or, with the exception of the European Union, do not have a legally binding effect

between countries. The UNCITRAL Model Law, which provides a good example for how a country may structure its insolvency legislation, leaves it to each country to consider whether and to what extent it makes use of its provisions. Accordingly, the legal underpinning is basically national in nature, whilst the cross-border insolvency problems considered in this part of the report are multi-jurisdictional. If a legal response were to be designed to address this lack of congruence between subject matter and legal and institutional arrangements, it would need to be at an international level.

Although international insolvency law is a complicated area where several perspectives and interests have to be taken into account, the increased level of cross-border trade and financial activity (and, indeed, the globalisation of markets) has raised the awareness of the resulting potential risks of inaction. As a consequence, insolvency law reform is a topical question and progress is being made in individual countries and within the European Union, as can be seen from our findings above and the results of the insolvency and contract enforceability surveys conducted by the Contact Group. The topic of possible improvements to insolvency regimes is also attracting much attention from the many international organisations dealing with this and connected matters, some of which are represented within the Contact Group. These developments indicate a convergence of views on the need and ways to address international insolvency issues, including specific legislative projects that represent positive examples. However, despite such positive legislative developments, most of them are primarily prepared at a national level and the solution to cross-border issues in practice most often remains based on comity of law and the voluntary cooperation between different national courts and authorities on an ad hoc basis. The UNCITRAL Model Law may illustrate the point since, even if it were to be adopted by a sufficient number of countries, interpretation would still be a matter for national courts, and may vary from country to country.

One positive multi-jurisdictional example of insolvency law reform is the new EU regime, which will be fully effective and binding in all 15 EU member states in 2004. The new EU legal acts have laid down a legal regime according to which the laws applicable with regard to the winding-up or reorganisation of an entity with a registered office or establishment in the European Union shall be the laws of its home state. The EU legal framework also benefits from the existence of a common court. The European Court of Justice has the authority to provide an authoritative interpretation of the rules on cross-border insolvency should any ambiguity or interpretation issue arise with respect to the application of the Insolvency Regulation or the Winding-up Directives for insurance undertakings and credit institutions.<sup>85</sup> In addition to the harmonisation of international private law rules in EU member states, legal certainty and clarity is thereby fostered by ensuring a coherent interpretation of the national laws transposing these EU legal acts. No relevant institutional arrangement of this kind exists at an international level beyond the boundaries of the European Union that could provide an authoritative interpretation of rules of a comparable international cross-border insolvency regime.

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<sup>85</sup> Article 234 of the Treaty establishing the European Community.

This new EU regime reflects the private international law principles of unity and universality of insolvency proceedings and could provide inspiration for a more ambitious international insolvency law project. Moreover, the widely accepted principles of supervisory cooperation drawn up by the Basel Committee on Banking Supervision, which are based on home country control and mutual recognition, could be expanded, where possible, to insolvency proceedings.



## **APPENDIX B:**

### **SURVEY RESULTS**

## **APPENDIX B1:**

### **INSOLVENCY ARRANGEMENTS**

Coverage:      European Union (EU)  
                  Italy (IT)  
                  Japan (JP)  
                  Netherlands (NL)  
                  England and Wales (UK)  
                  United States (US)

This annex surveys the answers given in the Questionnaire on the Resolution of Financial Institutions Through Insolvency Arrangements (June 2001). The questionnaire was answered by legal staff of the following jurisdictions' central banks: European Union (ECB), Italy, Japan, the Netherlands, the United Kingdom (discussing the law of England and Wales) and the United States (discussing federal law). The questionnaire elicited a brief general outline of the salient characteristics of insolvency law relevant to financial insolvency. This analysis of the questionnaire is in the same spirit: a thematic structure seeking significant regularities and distinctions among different jurisdictions' insolvency law. It is not therefore a detailed comparative study.

Most of the EU insolvency legislation is procedural, generally pointing to a unique primary proceeding for cross-border insolvencies. We shall therefore discuss the EU legislation only in connection with cross-border insolvencies.

This appendix deals with five broad issues:

- A. Kinds of proceedings
- B. Purposes of proceedings
- C. The players
- D. Mechanics of proceedings
- E. Cross-border insolvency

### A. Kinds of proceedings

Table I seeks to categorise the kinds of insolvency proceedings. It uses standard distinctions among insolvency proceedings: liquidations, compositions (requiring creditor consent: either unanimous or supermajority) and reorganisations (also known as “administrations”, not necessarily requiring creditor consent.) The line between compositions and reorganisations can be very subtle: a pre-packaged reorganisation has elements of both. One category is unique to banks: the liability transfer.<sup>1</sup>

Two jurisdictions - the United States and Japan - also have proceedings that resolve insolvent banks by injections of public capital. This technique is not truly an insolvency proceeding, because insolvency proceedings are generally defined as resolving firms whose assets are inadequate to timely pay their liabilities. Furthermore, although Japan and the United States may be unique in their legal regulation of public capital injection, most sovereign states have the power to inject capital, by legislative appropriation if not legal regulation.

Table I lists general and bank-only proceedings separately. Because the questionnaire did not use the categories of Table I, there is some subjectivity in the compilation.

**Table I**

	<b>IT</b>	<b>JP</b>	<b>NL</b>	<b>UK</b>	<b>US</b>
General liquidation	Y	2	Y	Y	Y
General composition	Y	Y	Y	2	N
General Ch 11 reorganisation	2	2	N	N	2
General liability transfer	N	N	N	N	N
Bank liquidation	Y	N*	N*	N*	3
Bank composition	N	N	N	N*	N
Bank reorganisation	Y	N*	Y	N*	2
Bank liability transfer	Y	Y	Y	N	Y

\* No special bank proceeding. Jurisdiction uses general insolvency law for banks.

“2” and “3” refer to the number of processes under this heading.

The categories used in Table I are often broader than those used by the jurisdictions that created the proceedings. In other words, a jurisdiction may have multiple proceedings within the same category. For example, Japan has two liquidation proceedings: a low-cost one with significant creditor involvement (“Special Liquidation”), and a more conventional liquidation. Italy appears to have two kinds of reorganisations: a temporary moratorium for transitory

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<sup>1</sup> Liability transfers are also not unknown in insurance insolvency law.

liquidity crises (which is a general reorganisation), and a special reorganisation for larger firms. England has two separate compositions: one which binds all creditors, and another which binds only consenting creditors. Alternative proceedings within the same category also exist in bank insolvency, especially in Japan and the United States.

Significantly, Table I contains several null sets. No jurisdiction has specialised bank compositions. Also, liability transfers are unique to banks. No jurisdiction uses these proceedings for non-financial firms. The lack of bank compositions is easy to explain: meaningful negotiation and consent over a broad depositor base is out of the question.

The lack of non-bank liability transfers is more puzzling. Liability transfers compare well with reorganisations in principle. It is worth noting that liability transfers are inconsistent with some basic legal notions of insolvency law. A workable liability transfer mechanism requires rapid and subjective valuation of the firm: something more administrative than adjudicative in nature. Bank insolvency law tends to be more administrative than general insolvency law, often dominated by an activist receiver, rather than a passive court.

Some jurisdictions (eg the Netherlands) do not have reorganisations, relying on a tiered structure consisting of 1) compositions, which 2) turn into liquidations if they fail. It is worth noting that - although some jurisdictions lack general reorganisations and some lack general compositions - all jurisdictions have at least one of these proceedings. As discussed above (and in the main body of the report), these two techniques can blur into each other, and taxonomic precision is probably not worth the effort.

Some jurisdictions only permit their banks to enter bank-specific proceedings, and do not make general proceedings available to their banks. The United States and Italy are examples. Other jurisdictions have a mixture of bank-specific and general proceedings, and banks may enter one or the other depending on circumstances. Japanese insolvency law is a good example, with highly specialised bank proceedings coexisting with general-law liquidations of banks. Dutch law is similar, although it appears to partake somewhat of the English model, which has no specialised bank proceedings.

There may be few universals with bank insolvency proceedings. However, if we look to trends, rather than universals, a few generalisations might appear. First, the slower kinds of proceedings are disfavoured in bank insolvency law. In other words, reorganisations appear disfavoured in bank insolvency law<sup>2</sup>, and private compositions seem extremely rare or non-existent. Some bank liquidations are very slow, but the trend appears to be towards the most rapid option of liability transfer. Second, and more importantly, bank insolvencies tend to favour an activist proceeding, at least when compared with ordinary insolvencies.

## **B. Purposes of proceedings**

Liquidations everywhere appear to have similar goals: the fair, expeditious and economical dismemberment of the insolvent for the benefit of the creditors. These goals are occasionally

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<sup>2</sup> The parent of Barings is still in administration. However, the bank itself was sold quickly.

in conflict. A fair proceeding (as lawyers view fairness) is not likely to be expeditious or economical. One sometimes wonders if the actual conduct of liquidations is consistent with these goals. The cost of administration - especially one conducted by private attorneys or accountants - can be extraordinarily high compared to the value of an estate.<sup>3</sup>

The explicit goals of reorganisations do not vary much either. All non-financial reorganisations are supposed to rehabilitate a firm with balance sheet problems (although Italy will also reorganise to cure management pathologies in financial services, and US securities liquidations have an implicit antifraud function). The chief mechanisms of rehabilitation are adjustments of debts, and replacement of management. However, “rehabilitation” may have different meanings in different jurisdictions, ranging from preservation of going-concern value to preservation of incumbent firms or jobs. The questionnaire did not examine the different meanings of “rehabilitation”. Nor did the questionnaire examine those reorganisations that are guided by the political branches of government, rather than by rules applied by a legal or administrative forum.

For some jurisdictions (especially the United States and Japan), these goals are modified for liability transfers, or bank insolvency law in general. “Least cost resolution”, “protection of financial stability”, “minimum disruption to the financial system”, and “depositor protection” are cited as objectives of bank insolvency law. Of these goals, only “least cost resolution” and “depositor protection” have metrics, albeit sometimes fuzzy ones. Unsurprisingly, the greater the difference between bank and ordinary insolvency schemes, the more likely a jurisdiction is to adopt different explicit goals for bank insolvency.

### **C. The players**

All insolvency proceedings must give some role to creditors, but this role can vary considerably, from running the proceeding to merely filing a claim. Apart from creditors, the parties to an insolvency proceeding are contingent: a matter of choice rather than necessity. Almost anybody can be a player - or can be denied a role. The list of possible decision-makers is long, including auditors, buyers of the insolvent firm, a court, creditors’ committees, incumbent management, a public receiver, a private receiver, regulators in a non-receivership capacity, politicians or shareholders.

We divide our discussion into three topics: initiation of an insolvency case, the administration of an insolvency and the special roles played by government agencies in some systems.

**Initiation** - As a general rule for non-bank liquidations, any party at interest can request that the court initiate an insolvency proceeding. Often (as with US or some UK proceedings), the debtor has the right to initiate the proceeding, without asking for judicial permission. Some countries have a narrow notion of parties in interest (debtor and creditor); others include such figures as statutory auditors, public prosecutors, or the like. Usually, an involuntary

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<sup>3</sup> In one recent cross-border bank insolvency proceeding, the receiver had collected around \$10 million, with all but \$1.75 million disbursed to it in administrative expenses. In *re Treco*, 240 F.3d 148, 159 (2d Cir. 2001). Creditors had not yet been paid anything.

proceeding requires a showing of actual insolvency (eg Japan, United States), but the rules can be more relaxed for voluntary proceedings. Some countries treat the initiation of reorganisations in the same way as liquidations. Others have different rules for reorganisations or compositions. Italy, for example, permits only the debtor to file for some reorganisations or compositions.

For bank insolvencies, two patterns emerge. In some jurisdictions (England, Netherlands), the regulator is treated as one of the parties in interest, as eligible as, say, creditors to petition for insolvency, but otherwise playing no special role. The other pattern (Italy, Japan, United States) gives a unique role to the regulator: either the only party with the power to initiate insolvency, or at least the only party with the power to initiate involuntary insolvency.

The United States and Japan furthermore have what can be described as an exception to standard bank insolvency processes, which involves additional layers of government more politically accountable than bank regulators. These “exceptional” proceedings are not typical bank insolvencies, even apart from the additional political involvement. They place systemic interests over those of a least-cost resolution (or similar institution-specific standard), and may involve extraordinary steps such as government recapitalisation of the failed bank. Nevertheless, these proceedings are part of the legal framework of bank insolvency law in the United States and Japan.

It should be noted that the de facto criteria of insolvency often depend more on the identity of the initiator than the legal rules. Many of the legal rules are fuzzy, or otherwise manipulable. In most cases, it is the initiator’s interpretation of these rules that determines the actual criteria of insolvency. This interpretation will certainly be guided by the initiator’s interests, especially if the initiator is a private party. The legal rules become more significant if court approval is required, especially if the court conducts a searching review of the request for insolvency.

**Administration** - There are two polar patterns of insolvency administration: *stakeholder-centred* and *Official-centred*. The ideal-type stakeholder-centred administration reconciles the diverse interests of the stakeholders in the insolvency: different classes of creditors, the shareholders, management, and the like. In such an administration, an administrator may have no role, or may have a relatively weak role. Compositions - which are the prototype stakeholder-centred proceeding - have a minimal judicial role: perhaps imposing a moratorium or serving as a mediator. In other stakeholder-centred reorganisations (such as US Chapter 11), the court has a somewhat more significant reserve role as an ultimate umpire, if consensus among the stakeholders cannot be reached. Even if this role is never exercised, it influences negotiations among the parties. The stakeholder-centred model is also applicable to reorganisations, although less so than it is in compositions. However, even in liquidations, collective stakeholder action may have a role to play. Creditors’ committees, for example, are common in liquidations.

An ideal-type Official-centred proceeding treats the responsible Official (known eg as “supervisor”, “receiver”, “administrator”, or “trustee”) as the only significant stakeholder. Such a proceeding reduces the creditors’ role to that of mere claimants against the

administrator, and the court's role to that of claims adjudicator and asset collector. Such an Official-centred proceeding sees no need for collective creditor action, and ultimately no need for creditors' committees, except maybe to appoint and supervise the administrator. In such proceedings, a court may also authorise various administrator actions, especially extraordinary ones. The court (and/or creditors' committees) would also supervise conduct and compensation of a private Official. The Official-centred model is applicable to liquidations (either piecemeal or going-concern) and liability transfers. It is by nature inapplicable to compositions, and is probably not the dominant model in reorganisations.

The pure Official-centred model may be strongest in Japanese and US bank insolvency proceedings. These proceedings have little role for creditors except as claimants. Many jurisdictions' bank insolvency laws have a limited role for creditors. Creditors' committees are not found in US, Japanese, and Italian bank insolvency law, and are optional (to the court) for Dutch bank insolvencies. Creditors' committees are more common in non-bank proceedings. Creditors' committees or courts are usually used as a form of control over the administrator, even in Official-centred proceedings. Few jurisdictions allow an Official to operate completely without judicial and/or creditor supervision. Japanese bank insolvency law appears to be the exception here: the bank regulators appear to control the entire process, without judicial intervention.

As a general rule, the Official-centred model tends to be dominant in liquidations and bank insolvencies. Compositions, by nature, are stakeholder-centred. Reorganisations tend to vary. The US Chapter 11 proceeding - possibly at one extreme - appears as stakeholder-centred as any composition. Incumbent management tends to administer the insolvent firm, creditors' committees are institutionalised, and creditor consent (at least a supermajority in each class) is usually expected, if not required as a matter of law.

**Extraordinary Government Role** - Some insolvency regimes have additional players, in addition to the ones discussed above. The SEC is entitled to play a role in US reorganisations, although it usually chooses not to do so. Statutory auditors have the power to initiate Japanese insolvencies, although they generally do not do so. The Ministry of Industry plays a role in the Italian large-firm special reorganisation (*amministrazione straordinaria*). Italian insolvency law seems to distinguish private insolvencies from insolvencies affected with a public interest. The latter insolvencies have greater governmental and less judicial involvement.

#### **D. Mechanics of proceedings**

**Scope of the proceeding** - The scope of an insolvency has several dimensions, including timing, entity coverage, property coverage and jurisdiction:

- **Timing:** Which transactions are affected by an insolvency, and which are deemed final, and outside the scope of the proceeding? This issue is closely related to payment finality. Most of the jurisdictions polled permit some pre-insolvency transactions to be reversed or avoided: usually "preferential" or "fraudulent" ones. The scope of reversible preferential and fraudulent transactions is often curtailed for financial contracts or contracts involving

banks (eg the United Kingdom, the United States). Most jurisdictions have abandoned the “zero hour rule,” which unwinds transactions made from midnight of the day of insolvency, rather than the actual time of insolvency.

- **Entity:** Which entities are swept up in an insolvency proceeding? What is the definition of an entity? Most jurisdictions treat the legal entity as the basic unit of insolvency. They generally respect the corporate veil in insolvency, treating each legal entity within a corporate group independently. This does not necessarily mean that an insolvency only affects the legal entity: a moratorium or stay can immobilise a substantial amount of property that is only indirectly associated with the entity. The United States contains a notable exception to entity treatment for bank insolvency: all commonly owned insured banks cross-guarantee each other in insolvency as a matter of law.
- **Property:** What property is attributed to the entity in insolvency? Bailments and trusts controlled by the entity? Letters of credit for which the insolvent entity served as applicant? Property conditionally transferred from the entity, eg secured property, leases? (This question is at the core of asset securitisation practice: whether a “true sale” has transferred property away from the insolvent entity.) This issue was outside the scope of the questionnaire.
- **Jurisdiction:** The jurisdictional scope of insolvency will be discussed in a later section, on cross-border insolvencies.

**Stay** - Some kind of stay or moratorium is necessary in insolvency law: at the very least a moratorium on unsecured creditors seizing assets of the debtor. However, beyond this minimum, practice varies widely among jurisdictions. Some jurisdictions provide the stay automatically; others require court approval (which may or may not be routine). The treatment of collateral varies among jurisdictions. Some jurisdictions permit secured creditors to exercise their rights in insolvency proceedings (notably the United Kingdom, except for reorganisations); others stay almost all creditor proceedings (US or Japanese general insolvency law). US law stays even setoffs. Several legal systems permit a payment moratorium for reorganising banks (eg the United States, the Netherlands), but do not employ this option in practice.

Financial contracts are generally excepted from stays.

**Duration** - The duration of insolvency proceedings varies, depending on the nature of the insolvent firm. A fraud-ridden major firm, for example, will take longer to liquidate than a small honest insolvent. Contingent liabilities and illiquid assets (eg real estate) slow liquidations. Reorganisation speeds depend on negotiation processes and uncertainties: typically over a year.

Doubtless some jurisdictions are faster than others, but major financial insolvencies are rare, and good empirical data are hard to come by. Even if the jurisdictions could be compared, a difference in speed might be attributable to many factors beside the legal environment: complexity of insolvent firms, practices of local insolvency officials, number of creditors, etc. It is difficult, therefore, to attribute insolvency speed to legal rules. About all that can be said



is that liquidations and reorganisations usually take years and liability transfers are (by comparison) very fast. It is also worth noting that netting and closeout ensure the very rapid resolution of financial contracts, regardless of the duration of the main insolvency proceeding.

**Role of the pre-packaged insolvency** - The pre-packaged insolvency seems limited to US reorganisation practice. This process requires extensive advance negotiation among stakeholders, which can often take years. However, once affected stakeholders have agreed, the time between filing and disposition of a reorganisation case can be very short: a few months or less.

#### **E. Cross-border insolvency**

Cross-border insolvency law accommodates two polar extremes: universality and territoriality. A territorial insolvency law prescribes separate (and most likely uncoordinated) liquidations of the assets and liabilities located in different jurisdictions. Reorganisation is inconceivable in such a scheme. Universal insolvency law has one jurisdiction in charge of the insolvency (the “unitary” principle), with the courts of other jurisdictions limited to marshalling assets for the centralised proceeding, in an “ancillary proceeding”. Full universality requires a tremendous degree of international coordination: tantamount to an insolvency treaty. Modified universality can be accomplished through decentralised cooperation by sovereign legal systems.

The European Union represents the most fully universalistic system of the jurisdictions polled in the questionnaire. It has separate systems for general insolvency proceedings, credit institution insolvency, and insurance insolvency. All of these systems address similar goals. They seek to establish a clear main proceeding, to which ancillary proceedings may attach. The European Union’s general insolvency law (a Regulation) permits (but discourages) secondary proceedings. (The liquidator of the primary proceeding has the power to stay secondary proceedings in the European Union.) Its bank insolvency law (a Directive) prohibits secondary proceedings. Of course, these prohibitions and restrictions on secondary proceedings are only applicable within the European Union.

Based on the questionnaire, most insolvency regimes employ some modified degree of universality. Although US bank insolvency law is universalistic for banks chartered in the United States, it is territorial for foreign banks with branches in the United States.

Cross-border insolvency is discussed in greater detail in the main text, and especially Appendix A.

## **APPENDIX B2:**

### **CONTRACT ENFORCEABILITY**

#### **A. Introduction**

Issues relating to the content and interpretation of a contract (and remedies in relation to breach of a contract) are of substantial importance in the context of the relationships between financial institutions. In particular, where the parties to a contract either expressly document their rights and obligations on certain terms, or assume that certain consequences will be implied in any event, then any matter which adversely affects or varies the performance or interpretation of those rights and obligations in accordance with their agreement or implied assumptions will be problematic.

It is of course necessary for the parties not only to *document* in the contract their respective rights and obligations in as clear a manner as possible, but also for them to ensure that the *legal framework* in which the performance of those rights and obligations is placed will promote certainty and predictable results.

The relevant legal framework will consist of the *general laws and legal principles* that apply with regard to the law by which the contract between the parties is governed, but also possibly (and especially for cross-border transactions) the laws of other jurisdictions relating to the place(s) of incorporation and carrying on of business of the parties, and in some cases the place(s) of location of any collateral.

Furthermore, the legal framework may distinguish between the performance/enforcement of rights and obligations where a counterparty is or is not subject to insolvency proceedings or reorganisation measures; in addition, those proceedings/measures may also apply differently to counterparties that have a particular status (eg financial institutions, such as banks and investment firms) or where the financial transactions concerned are of a particular type (eg repurchase agreements, stock loans or derivatives contracts) or are entered into or traded on a particular market (eg on an exchange or in the OTC market) or settled or cleared through a securities settlement system or clearing house.

This paper therefore synthesises the information collected through responses from a number of jurisdictions to a contract enforceability questionnaire (as described in B below). A summary of the principal issues addressed in the synthesis is set out in C below<sup>4</sup> and a summary of responses relating to the specified jurisdictions is set out in Appendix 1.

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<sup>4</sup> The paragraph numbers correspond to the question numbers in the summary of responses at Appendix 1.

## **B. Contract enforceability questionnaire**

A questionnaire (the contract enforceability questionnaire) was designed to collect information on the effect of insolvency arrangements<sup>5</sup> for financial institutions on the performance of financial contracts. The contract enforceability questionnaire is to be read as supplemental to the questionnaire (also prepared by the Contact Group) on the resolution of financial institutions through insolvency arrangements (the insolvency arrangements questionnaire). In particular, respondents were asked to consider various questions with respect to *each* of the various insolvency arrangements mentioned by them in the insolvency arrangements questionnaire, with a view to highlighting their effect in *general terms* on the performance of financial contracts.

For the purposes of the contract enforceability questionnaire it was, however, only intended that respondents focus on the of impact of insolvency arrangements on certain aspects of financial contracts: namely, the operation of closeout netting and set-off,<sup>6</sup> the realisation of collateral (whether provided under a security interest or an absolute transfer of title mechanism)<sup>7</sup> and the finality of settlement of payments and transfers of securities pursuant to financial contracts.

A copy of the contract enforceability questionnaire is set out in Appendix 2.

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<sup>5</sup> For the purposes of the contract enforceability questionnaire, the term “insolvency arrangements” includes both measures intended to bring about a winding-up or dissolution of the distressed institution, and reorganisation measures intended to bring about a rehabilitation, restructuring or reorganisation of the distressed institution as a going concern.

<sup>6</sup> “Closeout netting” means any procedure whereby the outstanding performance of contracts between the parties is terminated, and a net payment becomes due from one party to the other calculated by reference to the aggregate values (typically, using market values) thereof. “Setoff” means any procedure whereby the amounts due from one party to the other party are discharged through their aggregation against amounts due from that other party to the first party. Obviously closeout netting and setoff are generally closely related for the purposes of the enforceability issues dealt with in the contract enforceability questionnaire.

<sup>7</sup> A “security interest mechanism” involves the ownership to the collateral being retained by the collateral provider, and the creation (say, through the means of a pledge or charge) of a security right in favour of the collateral holder, whereby, in the case of a default, the collateral holder has the ability to sell or otherwise realise the collateral and apply the proceeds in satisfaction of the obligations for which the collateral was provided. An “absolute transfer of title mechanism” involves the transfer of absolute title to the collateral from the collateral provider to the collateral holder, and, in the case of default, the value of the contractual obligations of the collateral holder to subsequently redeliver or retransfer equivalent collateral to the collateral provider being set off or netted against the value of the contractual obligations for which the collateral was provided. Both mechanisms are utilised for the taking of collateral in the financial markets.

## **C. Summary of principal issues addressed by the questionnaire on contract enforceability**

### **1. Supportive regime for closeout netting/setoff [Question 1 (A), (B), (D)]**

A legal regime that is supportive and gives effect to closeout netting and set-off is important to the efficient functioning of the financial markets (eg it enables counterparties with certainty to terminate and crystallise their obligations - and possibly, associated hedging - under market contracts when their counterparty is in default and may no longer be able or willing to perform due to insolvency or reorganisation; it enables them to calculate their exposures on a net as distinct from a gross basis; and it avoids the risk of “cherry-picking” by insolvency officials).

The responses reveal that there are perhaps two approaches. Either the *general* law is supportive of netting/closeout whether prior to or following insolvency (and there is thus no uncertainty as to whether it is enforceable) or, in the event that the underlying legal regime is naturally hostile to netting/closeout, then a *special regime* is created whereby a certain category of institutions (such as, say, banks/financial institutions) and/or a certain class of contracts (such as forex, swaps, derivatives) are somehow “carved out” from the operation of what might otherwise be the adverse effects of the general law.

The two approaches are of course not necessarily mutually exclusive (eg the UK regime, which is generally supportive of netting/closeout, also has special regimes for certain financial markets and securities settlement/payment systems). Each approach might be said to have its limitations. For example, even though the general law might be favourable to netting/set-off, there might still be features of risk reduction techniques prudently employed in the financial markets that are offensive to or at least not recognised by the normal principles of insolvency law (eg the operation of “multilateral” netting as distinct from “bilateral” netting in the context of exchanges and clearing houses). Also, a danger of the special regime approach might be that there are some market counterparties who fall outside the category of qualifying counterparties, and/or types of market contract that are not within the class of protected contracts (eg because such counterparties or contracts were merely not included or because the market players/types of product have moved on from the time when the relevant legal provisions were drawn up).

### **2. Mandatory valuation parameters on closeout [Question 1(C)]**

The existence of a *mandatory* regime might mean that on closeout the valuation of outstanding financial contracts must be done in a certain way or at a certain time (eg the date of the making of an insolvency order, irrespective of when closeout occurred) or that the liquidator has the ability to determine such valuation at its discretion. Other relevant areas might be the application of mandatory forex conversion rates into a base currency for obligations denominated in foreign currencies. Such provisions would be problematic if the results or application of these provisions produced a valuation of closeout values or net exposures *different* to that which the parties themselves might have assumed to be the case (eg

for the ongoing calculation of credit exposures, but perhaps also for the provision of margin/collateral on a marked to market basis).

A regime which recognises the ability of the counterparties to agree on methods of calculation/valuation of outstanding obligations, and for those provisions to be contractually effective both before and after insolvency, is therefore to be preferred from the perspective of certainty for the parties. However, a residual right for the insolvency official to challenge contractually agreed provisions or a general requirement that any such provisions should only be effective to the extent they achieve a commercially reasonable result, or are to be judged by reference in some manner to market values, ought not to be problematic.

The responses indicate that there are in general no mandatory valuation parameters on closeout.

### **3. *Supportive regime for collateral enforcement (security interest) [Question 2(A)]***

Any insolvency procedures (or general provisions of law) which impose a stay on execution of security or have the effect that security can only be realised/enforced subject to court consents being obtained or sale through particular mechanisms (such as public auction) are problematic. In particular, if a collateral holder is managing exposures on the basis of outstanding obligations against the marked to market values of collateral, then any delay in the realisation of security might lead to timing delays and possible mismatches between the level of exposures and the amount of proceeds available to meet those exposures.

The responses show that in some jurisdictions there are such impediments as a consequence of the application of reorganisation measures whereby the enforcement of security is subject to stays or mandatory delays. However, in other jurisdictions there are special protective regimes whereby the realisation of security is not affected by reorganisation measures. As an alternative to taking collateral through a security interest, repos and absolute transfer of title agreements may be used. In this case it is, however, imperative that the legal regime is supportive of netting and set off (being the mechanism through which market values of margin securities are set-off against credit exposures). It would of course be problematic if any legal regime would impede the use of closeout netting/setoff by, say, making these also subject to stays (it does not appear that any responses have highlighted the possibility that netting/set-off might also be subject to stays imposed through reorganisation measures).

Taken as a whole, one might conclude that collateral taken for financial contracts is in practical terms insulated or isolated from the effects of insolvency arrangements (whether liquidation or reorganisation measures) either through the use of a security interest or by netting/closeout and absolute transfer of title mechanisms.

It is worth noting that the the EU Collateral Directive is intended to put in place a protective regime for counterparties (generally speaking, public bodies, financial institutions and their

counterparties, if not natural persons) taking “financial collateral” that consists of transferable securities and cash, *irrespective* of the purpose or type of the underlying transaction.<sup>8</sup>

#### **4. Possible treatment of finance leases/title retention as quasi-security [Question 2 (B)]**

The recharacterisation (ie for the purposes of insolvency arrangements) of the terms of finance leases, hire purchase and title retention arrangements as some form of “quasi-security” might have the effect of treating the relevant property as being (or continuing to be) in the ownership or control of the company concerned. The intention would be, whilst a reorganisation measure is operative, to allow the company to retain the possession and use of this property with a view to the business of the company being carried on as a going concern. This feature is of course most obvious in the case of property that is, say, fixed plant and machinery. However, it is likely that this aspect of contract enforceability will be of less or little significance to banks/financial institutions in the context of financial contracts and the type of collateral typically provided thereunder (eg securities as margin).

#### **5. Effect of restructuring on secured creditors [Question 2(C)]**

Obviously (for the same reasons as mentioned in relation to question 3 above), in the context of financial contracts, the insulation of secured property rights from the effect of a restructuring is essential from the perspective of the ability to realise security in a timely and efficient manner. See also the responses to question 3 above (eg in the sense that restructuring may involve stays on enforcement of security). Taken as a whole, the responses do not indicate that the holders of security in the context of financial contracts are subject to the possibly adverse effects of a reconstruction, although it in some cases may result in temporary stays on enforcement.

#### **6. Existence of mandatory/preferred creditors [Question 2(D)]**

The existence of a mandatory regime for the prior payment or discharge of certain preferred creditors (such as the costs of liquidation or reorganisation expenses, taxes and social security costs/expenses) would be problematic if it resulted in a secured creditor not receiving the full proceeds of the realisation of security (and where such proceeds might have been taken into account in making any calculation of credit exposures against marked to market values of collateral). From the responses, it would appear that none of the jurisdictions has (at least to any substantive effect) any regime for preferred creditors, either in relation to the realisation of collateral through a security interest mechanism or in relation to the operation of setoff.

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<sup>8</sup> For further details, see the General Introductory Remarks of the responses to the contract enforceability questionnaire prepared by the European Central Bank.

**7. Supportive regime for top-up/substitution of collateral (security interest)**  
**[Question 2(E)]**

The preferred situation here would be for the legal regime not to render void or unenforceable the delivery of collateral or top-up/substitution of collateral that had been made in good faith, in accordance with the terms of a collateral arrangement. Most problematic would be legal provisions whereby the delivery of collateral is *automatically* void if delivered in a suspect period prior to the commencement of insolvency proceedings whether or not the parties were aware of the commencement of such proceedings or making of an insolvency order (“zero hour rules”). A regime under which such delivery *may* be rendered void depending on a case-by case decision of the court (eg., where the intention of the parties was fraudulent with a deliberate intention to prefer one party over the general creditors) ought not necessarily to be problematic (eg if, say, deliveries of collateral made in good faith in accordance with the existing contractual obligation of the parties would remain valid). Ultimately, it is a policy decision as to where the balance of public interest lies between protecting deliveries of collateral made under financial contracts and the equal treatment of creditors generally from the preferential effects of dispositions of property in suspect periods prior to the commencement of insolvency arrangements.

From the responses, it would appear that in most jurisdictions there is no absolute protection for top-up/substitution of collateral against insolvency challenges, but rather that a delivery of collateral may be (as distinct from being automatically void) challenged on a case by case basis (such as where the transfer was fraudulent, deliberately preferential or not made in the ordinary course of business).

See also the comment on question 3 above relating to the EU Collateral Directive.

**8. Supportive regime for onward pledge/right of use [Question 2(F)]**

A legal regime whereby a collateral taker is able (subject to the consent of the collateral provider, if necessary) to use collateral for its own purposes (which might be for use as collateral or to on-deliver in the case of the settlement of sale contracts entered into by it) promotes the efficient use of collateral and liquidity/recirculation of assets in the market. Obviously, there are credit risk implications in that the collateral provider might no longer retain proprietary rights to the specific collateral provided by it (ie should the collateral taker itself go into bankruptcy or liquidation, then the collateral provider merely has an unsecured contractual claim for the redelivery of equivalent collateral). Where a right of re-use is not permitted or invalid at law, then the use of repo and absolute transfer of title mechanisms for collateral purposes is essential. Taken as a whole, the responses seem to indicate that the legal framework in the various jurisdictions is supportive of the reuse of collateral.

**9. Recognition of repo/absolute transfer of title [Question 3(A)]**

The recognition of the enforceability of repo or absolute transfer of title to collateral is an important element in the underpinnings of the financial markets. In particular, repo/title transfer are used as a mechanism to avoid the disadvantages of taking collateral through a security interest (eg to avoid registration and other specific formalities, realisation being

subject to court consents and public auction procedures or the possibility of mandatory stays imposed as a result of reorganisation measures), and because the collateral provided can be used by the collateral taker for its own purposes (which may not, for legal reasons, be possible in some jurisdictions where collateral is taken through a security interest) and therefore be recirculated in the market.

It is therefore problematic if repo/title transfer is capable of being recharacterised (eg as a disguised security interest) or is the subject of legal uncertainty as to whether it is effective. Recognition should, moreover, extend not merely to the *original* securities that are the subject of the repo/title transfer, but also any further securities provided as *margin*). The responses indicate some uncertainty as to whether absolute transfer of title (as distinct from repo) is recognised as valid, and whether the delivery of further securities as margin is recognised is also the subject of some legal uncertainty.

**10. Supportive regime for top-up/substitution (absolute transfer of title) [Question 3(B)]**

For the same reasons as mentioned in relation to question 7 above, it is beneficial that deliveries of margin under a repo or absolute transfer of title mechanism are also legally effective.

**11. Finality of securities settlement/payment transfers [Question 4(A)]**

Quite apart from the transfers of securities and payments that might take place in the context of outright transfers and margin transfers between the counterparties to a financial contract (and the possible characterisation/challenge on insolvency grounds of those transfers as made between them), a separate area is the transfer of securities and payments made by them through securities settlement and payment systems (and whether between them as “participants” those transfers are final and cannot be challenged on insolvency grounds). In the latter case, the consideration of and response to systemic risk that arises as between those participants and the wider financial system might justify a different treatment from an insolvency perspective (ie in the sense of how liquidation and reorganisation measures should impact on transactions carried out by participants through such systems). In the European Union, this area has been the subject of specific legislative intervention.

**12. Formal co-ordination of cross-border insolvency [Question 5(A)]**

Issues surrounding what are and whether there ought to be formal procedures for dealing with cross-border insolvencies (eg where a counterparty has operations or dealings in a number of jurisdictions) are complex. In the context of the enforceability of financial contracts, it is particularly relevant to establish whether such procedures make certain (or make any less certain) the rights of counterparties under financial contracts where a particular governing law for the agreements in question is interpreted (or has been assumed) as giving a level of predictability as to how such matters as rights of set-off and realisation of collateral will be affected by the onset of insolvency arrangements.



In this regard, it is instructive to note that the insolvency coordination provision of the various EU Regulations and Directives<sup>9</sup> contain a number of exceptions from the operation of the primacy of the insolvency laws of the “home” state (ie the state of establishment of a credit institution) and therefore the characterisation of rights of creditors and others according to the insolvency principles of that jurisdiction. These exclusions are highly relevant to financial contracts: namely, laws governing rights *in rem* (eg security) located in another EU member state, the laws of claims under which rights of set-off are determined, the governing laws of netting and repurchase agreements, the laws governing transactions carried out in the context of certain regulated markets, and the laws governing transactions carried out in the framework of designated securities settlement/payment systems.

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<sup>9</sup> For further details see the responses to the contract enforceability questionnaire prepared by the European Central Bank, especially the response to question 1(A).

**APPENDIX 1: Legal and institutional underpinnings - contract enforceability**

<b>LEGAL AND INSTITUTIONAL UNDERPINNINGS - CONTRACT ENFORCEABILITY</b>					
Issue	Italy <sup>i</sup>	Japan <sup>ii</sup>	Netherlands <sup>iii</sup>	UK <sup>iv</sup>	US <sup>v</sup>
1 Supportive regime for closeout Netting/Setoff [Question 1 (A), (B), (D)]	Yes – special regime <sup>vi</sup>	Yes – general law <sup>vii</sup>	Yes – general law <sup>viii</sup>	Yes – general law <sup>ix</sup>	Yes – special regime <sup>x</sup>
2 Mandatory valuation parameters on closeout [Question 1(C)]	Yes <sup>xi</sup>	No <sup>xii</sup>	No <sup>xiii</sup>	No <sup>xiv</sup>	No <sup>xv</sup>
3 Supportive regime for collateral enforcement (security interest) [Question 2(A)]	No <sup>xvi</sup>	No <sup>xvii</sup>	No <sup>xviii</sup>	Qualified <sup>xix</sup>	Yes –special regime <sup>xx</sup>
4 Possible treatment of finance leases/title retention as quasi-security [Question 2 (B)]	Yes <sup>xxi</sup>	Yes	No	Yes <sup>xxii</sup>	Yes
5 Effect of restructuring on secured creditors [Question 2(C)]	Yes <sup>xxiii</sup>	No	No	No	No <sup>xxiv</sup>
6 Existence of mandatory/preferred creditors [Question 2(D)]	Yes <sup>xxv</sup>	No <sup>xxvi</sup>	No	Qualified <sup>xxvii</sup>	No
7 Supportive regime for top-up/substitution of collateral (security interest) [Question 2(E)]	Qualified <sup>xxviii</sup>	Qualified <sup>xxix</sup>	Yes <sup>xxx</sup>	Qualified <sup>xxxi</sup>	Yes – special regime <sup>xxxii</sup>

8 Supportive regime for onward pledge/right of use [Question 2(F)]	Yes	Yes	Yes	Yes	Yes <sup>xxxiii</sup>
9 Recognition of repo/absolute transfer of title [Question 3(A)]	Yes <sup>xxxiv</sup>	Yes	Yes <sup>xxxv</sup>	Yes	Yes <sup>xxxvi</sup>
10 Supportive regime for top-up/substitution (absolute transfer of title) [Question 3(B)]	Yes	Qualified <sup>xxxvii</sup>	Qualified <sup>xxxviii</sup>	Qualified <sup>xxxix</sup>	Yes
11 Finality of securities settlement/payment transfers [Question 4(A)]	Yes <sup>xl</sup>	No <sup>xli</sup>	Yes <sup>xlii</sup>	Yes <sup>xliii</sup>	Yes <sup>xliv</sup>
12 Formal coordination of cross-border insolvency [Question 5(A)]	Qualified <sup>xliv</sup>	Qualified <sup>xlvi</sup>	Qualified <sup>xlvii</sup>	Qualified <sup>xlviii</sup>	No <sup>xlix</sup>

## Endnotes

- i Under Italian law, there are (save as mentioned in the footnotes set out below) no material differences as to the consequences/effect of the application of the various insolvency and reorganisation regimes, and whether they apply in the case of banks/other financial institutions or ordinary corporates.
- ii The Japanese responses were given in the context of insolvency arrangements involving judicial proceedings. They therefore exclude, say, bank insolvency involving administrative proceedings, such as Purchase and Assumption. However, such administrative proceedings do not have any additional adverse impact on the ability of counterparties to exercise their rights under financial contracts (eg netting/closeout and realisation of collateral).
- iii The Dutch responses were given in the context of two insolvency regimes – a regime for companies generally, and a regime for banks. Given that there are hardly any material differences between the two types of regime, then no distinction has been made in the tables and in the footnotes set out below.
- iv Under English law, there are no separate insolvency arrangements that apply only to banks/financial institutions (ie there is only one insolvency regime applicable to both banks/financial institutions and ordinary corporates).
- v The US responses were given in the context of two insolvency regimes – a regime for bank insolvency, and a regime for insolvency generally which includes securities firms (but excludes insurance companies, which are subject to a separate insolvency regime not covered in the responses to the contract enforceability questionnaire).
- vi All *financial contracts* (eg forex forwards, securities lending and repos) are automatically closed-out and terminated on the declaration of bankruptcy irrespective of whether either or both of the counterparties are financial institutions or ordinary corporates. See also the response to question 11 below.
- vii The general law is supportive of set-off; in addition, there are specific legislative provisions that establish protective regimes which support the enforceability of closeout netting for particular types of entity (banks, long-term credit banks and securities firms) and particular types of contract (derivatives, swaps and options). The benefit of these provisions applies provided at least one of the counterparties is a financial institution (which includes insurance companies).
- viii Under Dutch law, the parties are free to contract for rights of netting or closeout automatically upon the happening of certain events or to give a discretion whether to act (eg on insolvency of one party). An exception would be for forward contracts entered into on an exchange, when a forward contract is automatically terminated on the declaration of bankruptcy of one of the parties.
- ix The general law is supportive of set-off and netting; in addition, there are specific legislative provisions that establish protective regimes which support the enforceability of closeout netting for particular types of contract entered into on certain financial markets and exchanges/clearing houses, and in the settlement of payment and securities transfer orders executed through certain designated payment and securities settlement systems. See also the response to question 11 below.
- x General US law is friendly to setoff, although there are some special cases where this right is limited (eg an issuer of a letter of credit cannot set off against its beneficiary, or a lessee cannot setoff against its lessor). US insolvency law is also relatively friendly to the *right* of setoff, although set off is subject to the automatic stay. There are, however, special regimes which remove the stay. These regimes apply in the case of *financial institutions* (ie banks/investment firms) exercising termination rights under certain types of *qualified financial contracts* (i.e. repos, stock loans and derivatives contracts) and when entering into *netting contracts*. Similar provisions exist for non-financial institutions in the case of *financial contracts* and netting contracts in relation to such contracts. However, the transfer of a failed bank's book to a "bridge bank" would stop a bank or non-bank counterparty from exercising any right of closeout netting.

- xi As a rule, the valuation of obligations and currency conversions is made by reference to replacement costs using market values at the date of the declaration of bankruptcy.
- xii The non-defaulting party has a contractual freedom to determine the valuation of financial contracts on closeout that is effective on insolvency subject to the valuation being fair based on market prices.
- xiii The non-defaulting party has a contractual freedom to determine the valuation of financial contracts on closeout that is effective on insolvency, although any such valuation may be subject to challenge by a receiver if it was not based on reasonable grounds. There is, however, a mandatory currency conversion rate for foreign currency obligations into euros to be applied as at the date of the declaration of bankruptcy.
- xiv Although the parties would have the contractual freedom to determine the method by which the valuation of financial contracts on closeout might be determined that is effective on insolvency, it is thought that a liquidator would have the ability to challenge any such valuation if it was not based on reasonable grounds. There is, however, a mandatory currency conversion rate for foreign currency obligations into pounds sterling to be applied as at the date of the making of a winding-up order.
- xv There are, as yet, no mandatory valuation provisions in US law and accordingly a non-defaulting party has a contractual freedom to determine the valuation of financial contracts on closeout that is effective on insolvency. Valuation provisions, as “liquidated damages clauses”, may, however, be subject to a test of reasonableness although, so far, US courts have validated most (or perhaps all) valuation agreements they have seen. It could be argued that the Payment System Risk Reduction Act will validate a valuation provision without regard to reasonableness, but this has not been tested in the courts. US insolvency law will also soon probably contain a prohibition of “walkaway agreements” (the most extreme example of valuation abuse).
- xvi Security can only be enforced with the consent of the court, but interest is due (though not paid) during the stay. See also the response to question 11 below (ie security in the context of participation in a designated securities settlement/payment systems has the benefit of a special protective regime).
- xvii The collateral holder’s right to enforce security is not prejudiced where the counterparty goes into bankruptcy or special liquidation. However, should the counterparty go into any other form of insolvency arrangement (ie corporate reorganisation, civil reconstruction or company arrangement), then the collateral holder’s rights to enforce its security may be subject to a compulsory stay for a certain period.
- xviii The collateral holder’s ability to enforce the realisation of collateral is subject to the court’s power to grant a stay on enforcement of up to two months following a declaration of bankruptcy or on other insolvency proceedings falling short of bankruptcy, such as Emergency Regulation/suspension of payments for banks. See also the response to question 11 below (ie security in the context of participation in a designated securities settlement/payment systems has the benefit of a special protective regime).
- xix The collateral holder’s right to enforce security is not prejudiced where the counterparty goes into bankruptcy or liquidation. However, should the counterparty go into administration (ie a form of corporate reorganisation), then the collateral holder’s rights to enforce its security are subject to a compulsory stay. Administration is, however, excluded in relation to special protective regimes that exist for certain financial markets and exchanges/clearing houses, and in designated securities settlement and payment systems (as mentioned in the response to question 11 below).
- xx Counterparties holding collateral for obligations in respect of qualified financial contracts (in the case of banks) and financial contracts (in the case of non-banks) are generally not subject to any court-imposed stays on realisation or enforcement. There is a possible exception for financial contracts involving non-banks, if the stay is authorised under the Securities Investor Protection Act of 1970. However, such a stay has not yet been problematic (and may not yet ever have been invoked).
- xxi If the intention of the parties is to use finance leases etc as disguised security, then they may be rendered void where failure to pay is being used as a trigger for the debtor’s title to the asset being terminated and transferred to the creditor.

- xxii Property held by a counterparty under such leases/title retention clauses is subject to a mandatory stay on repossession if the counterparty goes into administration (as referred to in footnote xix above).
- xxiii When a restructuring plan is authorised by the court (which generally depends upon the consent of a specified percentage of unsecured creditors), an automatic stay is imposed on all creditors (including secured creditors).
- xxiv In the case of non-bank insolvency, although secured creditors can be bound by a reorganisation (even against its will), this is not in practice material because security for financial contracts can be liquidated outside the restrictions (ie stays on enforcement) imposed by the normal bankruptcy regime.
- xxv Reorganisation costs (including labour costs relating to an authorised continuation of the enterprise) and liquidation expenses are given absolute priority before all creditors, including in particular secured creditors. Secured creditors do, however, rank ahead of tax and labour claims arising prior to the commencement of proceedings.
- xxvi In general, reorganisation costs/liquidation expenses, certain unpaid taxes and redundancy payments are preferred to other general claims. However, any proceeds realised from collateral belong to the collateral holder and are not subject to any other mandatory priorities.
- xxvii There is a category of preferred creditors (reorganisation costs/liquidation expenses, certain unpaid taxes, redundancy payments) that in an insolvent liquidation will be paid before all other ordinary unsecured creditors. However, secured creditors will in most cases rank ahead of these preferred creditors. Moreover, recent proposals of the UK government are for preferred creditors as a whole to be abolished.
- xxviii Substitution of collateral is valid. Top-up collateral delivered in a two-year suspect period prior to the date of declaration of bankruptcy may be treated as a “preferred payment” and declared null and void unless the counterparty proves that it was unaware of the state of insolvency of the debtor.
- xxix Collateral/top-up collateral delivered in a suspect period prior to the commencement of bankruptcy may be declared null and void.
- xxx The Dutch “zero hour rule” (ie the retroactive backdating of the effects of a bankruptcy order) applies to any collateral, top-up/substitution collateral delivered on the day of bankruptcy unless the collateral is used as security for payments, deliveries etc through designated settlement systems.
- xxxi Collateral/top-up collateral delivered in a suspect period prior to the commencement of bankruptcy may be declared null and void. Furthermore, deliveries of collateral made after the commencement of a winding-up petition, of a company that subsequently goes into insolvent liquidation, are void unless validated by the court. However, special protective regimes exist for certain financial markets and exchanges/clearing houses, and in designated securities settlement and payment systems (as mentioned in the response to question 11 below).
- xxxii Top-up and substitution collateral provided for in the context of an agreement (made in the ordinary course of business) relating to qualified financial contracts and financial contracts is valid and enforceable.
- xxxiii A collateral taker has the right of onward pledge, unless it has agreed to the contrary. For most classes of property, this right remains subject to the original collateral provider’s right of redemption. The most significant exception is for securities, which are not subject to the collateral provider’s right of redemption unless the onward collateral taker is aware of the provenance of the collateral. Therefore, in ordinary market transactions, the right of redemption is irrelevant.
- xxxiv Absolute transfer of transfer mechanisms outside repo (such as under an English law ISDA Credit Support Annex) may not be recognised.
- xxxv Absolute transfer of transfer mechanisms outside repo (such as under an English law ISDA Credit Support Annex) may not be recognised.
- xxxvi A transfer of title mechanism for securities that are not repo-eligible might be recharacterised by a court as a secured transaction, but secured transactions in securities may probably be liquidated, notwithstanding the automatic stay. Therefore, the parties will probably get the effect of repo recognition, although the court might not formally recognize an absolute transfer of title mechanism.

- xxxvii As for the response to top-up/substitution in the case of a security interest (as set out in footnote xxix).
- xxxviii Transfers of securities as margin do not expressly benefit from the statutory recognition of the repo transaction itself, although that they do so benefit has been subsequently confirmed by ministerial letter (the legal status of which is however, unclear).
- xxxix As for the response to top-up/substitution in the case of a security interest (as set out in footnote xxxi above).
- xl Under the Italian law implementation of the EU Settlement Finality Directive, netting of securities/payment transfer orders executed through, and collateral security provided in connection with participation in, certain EU designated securities settlement and payment systems has the benefit of a special protective regime from the adverse impact of insolvency laws.
- xli The possibility of challenge under usual insolvency principles (such as transfers made in suspect periods) appears to exist, and there is no special regime that protects transfers of securities and payments in the case of securities settlement and payment systems.
- xlii Under the Dutch implementation of the EU Settlement Finality Directive, instructions from a participant for payments or transfers of securities entered into an EU designated payment/securities settlement system are not affected by the retroactive backdating of a bankruptcy order (the zero hour rule) made in respect of such participant.
- xlili Under the English law implementation of the EU Settlement Finality Directive, netting of securities/payment transfer orders and security provided in the context of collateral for EU designated securities settlement and payment systems (as well as the context of the functions/operations of central banks) has the benefit of a special protective regime from the adverse impact of insolvency laws.
- xliv US payment and security transfer law is conducive to finality. Article 4A of the Uniform Commercial Code (UCC), for example, prescribes finality for payments made by wire transfer. Article 8 of the UCC, governing securities transfer and holding, does not contain the word “finality”, but implements the same concept since the scope for adverse claims is very limited. The concept of finality is also given statutory recognition in federal law, eg in the Payment System Risk Reduction Act, the financial contract exemptions from the automatic stay provisions of the Bankruptcy Code and the exclusion in the Bankruptcy Code from the estate of any post-petition transactions that left the estate without knowledge.
- xlv The prospective Italian implementation of various EU Directives and the application of EU Regulations will, in the context of EU-incorporated entities, put in place a framework of principles for identifying the place of principal proceedings (details provided in the responses to the Contract Enforceability Questionnaire prepared by the European Central Bank).
- xlvi The Law on Recognition and Assistance of Foreign Insolvency Proceedings appears to offer the possibility of recognition to a foreign insolvency official and, in some cases, for the effects of foreign (main) proceedings to be given effect in Japan (subject to certain safeguards, such as the interests of creditors in Japan not being prejudiced).
- xlvii The prospective Dutch implementation of various EU Directives and the application of EU Regulations will, in the context of EU-incorporated entities, put in place a framework of principles for identifying the place of principal proceedings (details provided in the responses to the Contract Enforceability Questionnaire prepared by the European Central Bank).
- xlviii The prospective UK implementation of various EU Directives and the application of EU Regulations will, in the context of EU-incorporated entities, put in place a framework of principles for identifying the place of principal proceedings (details provided in the responses to the Contract Enforceability Questionnaire prepared by the European Central Bank).
- xliv As regards banks, there do not appear to be any formal channels for coordination. For US-incorporated banks, proceedings in the United States are conducted in accordance with a universal approach. For foreign banks but with a US presence, proceedings in the United States are conducted in accordance with a separate entity/territorial approach. For foreign banks but with no US presence, as is also the case with non-banks, there is a legislative framework for coordination which would allow a foreign insolvency official to be recognised and have the ability to apply for relief in the United States (subject to certain factors, such as comity and fairness to US creditors).

## **How legal and institutional arrangements impinge on the efficiency and robustness of financial markets: the effect of insolvency arrangements for financial institutions on the performance of contracts**

### *Questionnaire for the Contact Group on institutional and legal underpinnings*

#### **Introduction**

This questionnaire has been designed to collect information on the effect of insolvency arrangements for financial institutions (and non-financial institutions with substantial activities) on the performance of financial contracts. It is to be read as supplemental to the questionnaire also prepared by the Contact Group on the resolution of financial institutions through insolvency arrangements.<sup>1</sup> In particular, participants are asked to consider the following questions with respect to *each* of the various insolvency arrangements mentioned by them in that questionnaire, with a view to highlighting their effect in *general terms* on the performance of financial contracts.

It is, however, only intended that participants focus on the of impact of insolvency arrangements on certain aspects of financial contracts: namely, the operation of closeout netting and setoff,<sup>2</sup> the realisation of collateral (whether provided under a security interest or an absolute transfer of title mechanism)<sup>3</sup> and the finality of settlement of payments and transfers of securities pursuant to financial contracts.

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<sup>1</sup> For the purposes of this questionnaire, the term “insolvency arrangements” shall include both measures intended to bring about a winding-up or dissolution of the distressed institution, and reorganisation measures intended to bring about a rehabilitation, restructuring or reorganisation of the distressed institution as a going concern.

<sup>2</sup> “Closeout netting” means any procedure whereby the outstanding performance of contracts between the parties is terminated, and a net payment becomes due from one party to the other calculated by reference to the aggregate values (typically, using market values) thereof. “Setoff” means any procedure whereby the amounts due from one party to the other party are discharged through their aggregation against amounts due from that other party to the first party. Obviously closeout netting and setoff generally are closely related for the purposes of the enforceability issues dealt with in this questionnaire.

<sup>3</sup> A “security interest mechanism” involves the ownership to the collateral being retained by the collateral provider, and the creation (say, through the means of a pledge or charge) of a security right in favour of the collateral holder, whereby, in the case of a default, the collateral holder has the ability to sell or otherwise realise the collateral and apply the proceeds in satisfaction of the obligations for which the collateral was provided. An “absolute transfer of title mechanism” involves the transfer of absolute title to the collateral from the collateral provider to the collateral holder, and, in the case of default, the value of the contractual obligations of the collateral holder to subsequently redeliver or retransfer equivalent collateral to the collateral provider being setoff or netted against the value of the contractual obligations for which the collateral was provided. Both mechanisms are utilised for the taking of collateral in the financial markets.



## 1. Closeout netting and setoff

- A. Do insolvency arrangements affect the ability of a counterparty to exercise any discretion to close out and terminate the outstanding performance of financial contracts or exercise any right of set-off in relation to the amounts due thereunder?

For example, notwithstanding the existence in those contracts of wording that gives the counterparty the ability to effect closeout netting or to exercise a right of set-off, might an insolvency official have the ability to render such a clause ineffective (eg because the insolvency official is legally entitled to be able to carry on or insist upon the performance of such contracts or to deal with them by way of transfer or assignment to a third party).

- B. If a counterparty is able to exercise such a right of termination and closeout, does this arise from the operation of general principles of law or only as a result of a special “carve-out”, protective regime or safe harbour, such as for particular types of counterparty (eg financial institutions, such as banks and investment firms only) or particular types of contracts (eg repurchase agreements, stock loans or derivatives contracts) or where the contracts are entered into or traded on a particular market (e.g. on an exchange or in the OTC market).

- C. Is the operation of closeout netting or the exercise of a right of set-off recognised as valid and enforceable (ie notwithstanding the commencement of insolvency arrangements), or is it only permitted or allowed subject to certain limitations or restrictions?

For example, notwithstanding the existence in those contracts of wording that gives the counterparty various discretions, are there any mandatory requirements that must be followed (eg for the valuation of obligations or the making of currency conversions, or that only certain types of obligation can be included in any closeout/setoff).<sup>4</sup>

- D. In the absence of any contractual provisions concerning the right to effect closeout netting or set-off, would such a right be implied in any event under the general principles of law as part of the insolvency arrangements.

## 2. Collateral (security interest mechanism)

- A. Do insolvency arrangements affect the ability of a collateral holder to enforce its security interest?

For example, would any such provision have the effect of imposing any mandatory stay or moratorium on the enforcement of security? If such a stay is imposed, does the

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<sup>4</sup> For example, in some jurisdictions (such as the United Kingdom) obligations can only be validly included in a setoff against an insolvent counterparty if those obligations are “mutual” (in the sense that they relate to obligations between the parties and not due to or from a third party) and if they were incurred prior to or without notice of the commencement of liquidation proceedings against the counterparty.

collateral holder receive any particular protections or benefits during the period of the stay (eg payment of contractual interest)?

- B. Are there any provisions of insolvency arrangements whereby financial leasing, hire purchase or title retention arrangements are also equated with the grant of security/treated in the same manner as secured transactions?
- C. To what extent, if any, can any restructuring plan effected pursuant to insolvency arrangements affect the existing rights of secured creditors?

For example, can a secured creditor be legally bound by such a plan, and where the plan might adversely affect its rights (eg result in any variation of an agreed contractual rate of interest or the ability of an insolvency official to dispose of the secured property). Does the secured creditor have any special protections available to it (such as separate voting rights), or can ultimately a plan be imposed without its consent)?

- D. In the event that the secured creditor liquidates the collateral, is its ability to retain or receive the realisation proceeds subject to any other mandatory priorities on distribution?

For example, are there any statutory preferred or preferential creditors (such as tax and social security authorities) with a prior ranking that must be discharged out of the proceeds?

- E. Would the substitution of the provision of top-up collateral,<sup>5</sup> be recognised as valid and enforceable, or is it subject to any limitations or restrictions by reason of insolvency?

For example, would it be subject to the possible application of invalidation provisions relating to suspect periods before the commencement of insolvency arrangements (eg preferences and gratuitous alienations, and “zero hour rules”)?

- F. Does the collateral holder have the ability (with the consent of the collateral provider if necessary) to onward pledge, sell or otherwise deal with or dispose of the collateral as absolute owner, and what rights does the collateral provider retain in or to such collateral?

For example, might such onward pledge or sale be legally impossible or lead to some sort of recharacterisation risk for the security interest, and what consequences might this have for the collateral provider and the collateral taker, and any transferee of the collateral?

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<sup>5</sup> “Substitution” is where any of the assets provided as collateral can be substituted with other assets of equivalent value. “Top-up” is where additional or further collateral is provided by reason of changes in the value of the collateral or the obligations secured, or on the occurrence of an external event (such as a credit rating downgrade of the collateral provider).

### **3. Collateral (absolute transfer of title mechanism)**

- A. Is the taking of collateral through the use of an absolute transfer of title mechanism recognised as valid and enforceable, or is it only permitted subject to certain limitations or restrictions?

For example, would any such absolute transfer of title mechanism be automatically void, or risk being “recharacterised” as a security interest (and therefore, notwithstanding the intention of the parties, be subject to the impact of insolvency arrangements on the grant of a security interest as mentioned above)? Furthermore, even to the extent valid and enforceable, would the realisation of the collateral (eg through the operation of netting/set-off) on default be subject to similar issues as mentioned in question 1(B) above.

- B. Would the substitution or the provision of top-up collateral as part of an absolute transfer of title mechanism be recognised as valid and enforceable, or is it subject to any limitations or restrictions by reason of insolvency arrangements?

For example, would it be subject to the possible application of invalidation provisions relating to suspect periods before the commencement of insolvency arrangements (eg preferences and gratuitous alienations)?

### **4. Finality of settlement of payments and transfers of securities**

Do insolvency arrangements affect the finality of the making of payments or transfers of securities by a counterparty pursuant to a financial contract?

For example, would such payments or transfers run the risk of being automatically void (eg under “zero hour rules”) or subject to claw-back by an insolvency official on a case by case basis (eg as preferences or gratuitous alienations), and would the same consequences apply in all cases (eg if those payments and transfers had been made by the counterparty in its capacity as a participant in a payment or securities settlement system)?<sup>6</sup>

### **5. General**

- A. Where a counterparty is subject to insolvency arrangements in another jurisdiction, is there any formal process for the coordination of the effects of the laws of both jurisdictions?

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<sup>6</sup> For example, under the EU Settlement Finality Directive, the settlement of transfer orders relating to payments and transfers of securities in a designated system is not to be affected by the onset of insolvency proceedings against a participant.

For example, is there a special regime or hierarchy of treatment as to which such law takes precedence, either in relation to the commencement of winding-up proceedings against the counterparty and/or in relation to its involvement in particular types of contract?<sup>7</sup>

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<sup>7</sup> For example, under the EU Winding-Up Directive on Credit Institutions, primary insolvency proceedings are to be commenced only in the member state where the credit institution has its head office, and according to the insolvency laws of that jurisdiction. In addition, under the EU Settlement Finality Directive, the rights of an insolvent participant in certain payment and securities settlement systems are determined according to the governing law of the system.

## **APPENDIX C:**

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## APPENDIX D:

### GLOSSARY OF LEGAL AND ECONOMIC TERMINOLOGY

This report draws heavily on technical economic and legal concepts, as well as notions familiar to bank supervisors. This glossary is a guide to these economic and legal arcana. Since the economic and legal concepts occasionally overlap, the glossary does not attempt to segregate them, but rather presents the defined terms in simple alphabetical order.

Bulk liquidation: Sale of the assets of an insolvent firm in bulk in order to preserve its going-concern value. A bulk liquidation could involve sale of the entire firm, sale of selected business lines, or sale of most of the firm while retaining some assets. (*See* “Piecemeal liquidation”.)

Chapter 11-style reorganisation: A reorganisation proceeding based on US Chapter 11 procedures. Such reorganisation proceedings typically involve: a central role for incumbent management in managing the firm during the insolvency proceeding, negotiations among stakeholders culminating in a “plan” approved by the court, “cram-down” (qv) provisions that bind dissenting stakeholders, an automatic stay that freezes creditors’ positions at the time of insolvency, and a priority given to financing during the course of the insolvency proceeding.

Comity: A legal term, referring to cooperation by courts of different jurisdictions. Comity may take several forms, eg enforcement of a foreign court’s judgments, deference to a foreign court’s proceedings, or cooperation with a foreign court in obtaining and sharing information. In international insolvency, comity usually takes the form of deference to a primary proceeding in another jurisdiction, collecting assets for the primary proceeding, and sharing and obtaining information. Comity is usually discretionary.

Composition: A reorganisation proceeding which typically has minimal judicial intervention: generally a stay on creditor’s rights during the pendency of the negotiations. The distinction between a composition and a “Chapter 11-style reorganisation” (qv) is blurred and generally not worth making.

Cram-down: A method of binding dissenting shareholders in a Chapter 11-style reorganisation. A cram-down generally requires supermajority approval of an affected class of shareholders, and subsequent judicial review for fairness. (Judicial review is necessary because members of a class might vote strategically, to advance their interests in other classifications of creditors.)

Deadweight loss (cost): An economic term referring to waste of a useful asset. Unnecessary administrative costs are common deadweight losses in insolvency. A piecemeal liquidation, insofar as it dissipates a firm’s going-concern value, also creates deadweight losses.

Estate: In insolvency law, refers to the assets associated with the insolvent party. In many jurisdictions, the estate includes hypothecated assets, which remain within the insolvency process even though they secure a debt of a creditor.

Externality: A cost (negative externality) or a benefit (positive externality) associated with an economic activity that does not accrue to an economic actor who embarks on the activity. For example, pollution can be a negative externality if the polluter need not pay for the damage done to the polluter's neighbours. Vaccination contains positive externalities, because a vaccinated person decreases an unvaccinated person's chance of acquiring a disease.

Firm-specific asset: An asset that loses substantial value if sold on the market, such as a specialised piece of machinery.

Forum shopping: Refers to the strategic selection of forum by an interested party. Depending on the circumstances, forum shopping may be neutral, detrimental, or even beneficial.

Liability transfer: Refers to legal procedures that transfer a liability from one party to another. The most common form of liability transfer is the corporate merger, but liability transfer proceedings also exist in specialised bodies of insolvency law, eg bridge banks.

Liquidation: An insolvency process that involves selling the insolvent firm's assets, and distributing the proceeds to creditors in accordance with insolvency priority rules.

Official: A single person responsible for the resolution of an insolvency: collecting assets, distributing insolvency proceeds, administering the affairs of the insolvent, and the like. An Official may be a public official or court, or a private person appointed to the task. In various jurisdictions, Officials are known as "receivers", "trustees," "administrators," "liquidators," or similar.

Official-centred proceeding: A kind of insolvency proceeding in which the key decisions are made by an Official, possibly subject to judicial review. Most liquidations are Official-centred; most reorganisations are not because they require stakeholder negotiations. (See "Stakeholder-centred proceeding.") Some procedures involving liability transfers are also Official-centred proceedings.

Pareto-optimal/superior: An economic rule, referring to legal rules or distributions of goods. A state of affairs is Pareto-optimal when no change can be made without making somebody worse off. A legal rule (or distribution) is Pareto-superior to another when at least one of the parties affected is better off and nobody is worse off.

Perfection: A security interest is perfected when the security interest is effective against third parties, notably the insolvency Official.

Piecemeal liquidation: The liquidation of an insolvent's assets without regard to a firm's going-concern value. (See "Bulk liquidation".) Sometimes, an asset-by-asset liquidation is more efficient, notwithstanding its effects on going-concern value.



PRIMA: “Place of the Relevant InterMediary Approach” is an acronym for a choice-of-law rule concerning securities accounts specifically, and accounts more generally. This rule looks to the location of the intermediary with whom the account is held, rather than the situs of the underlying property held by the intermediary, or the location of the account holder.

Priority inflation: An insolvency regime which claims worldwide jurisdiction will have an incentive to adjust priorities to favour local creditors, who would be paid out of worldwide assets.

Prompt corrective action: A bank supervisory concept, in which supervisors are expected to take timely action to rehabilitate a weak bank. If prompt corrective action works ideally, bank creditors need never take a loss, because supervisors will either rehabilitate the bank or - if unsuccessful - place the bank in insolvency while there are still adequate assets.

Reorganisation: An insolvency proceeding that seeks to retain the going-concern value of an insolvent firm by readjusting the claims of the firms’ creditors and - if necessary - readjusting the business of the firm. (See “Composition”, “Chapter 11-style reorganisation”.)

Special purpose vehicle: As an alternative to pledging assets, a debtor might “sell” them to a special purpose vehicle: a corporate shell whose only purpose is to hold the assets. The special purpose vehicle, in turn, pledges to the financier, and remits the financing to the original holder of the assets, as payment for the assets. The special purpose vehicle is structured so that it will not become insolvent, even if the debtor does. As a result, the insolvency of the debtor will not affect the special purpose vehicle, and the financier will be paid regardless of the debtor’s insolvency. If the legal form works out properly, the purpose of the transaction (secured financing of the debtor by the financier) is overlooked in favour of the form of the transaction (a sale of receivables to the vehicle).

Stakeholder-centred proceeding: A proceeding which involves extensive negotiations among creditors, management, and perhaps other stakeholders in the firm. Many stakeholder-centred proceedings are recognised in insolvency law (eg the composition or Chapter 11-style reorganisation); others - such as the workout - do not employ insolvency law.

Territorial model: A method of coordinating cross-border insolvency that has each jurisdiction conduct a separate insolvency proceeding over local assets.

Tort: A civil wrong, eg an automobile accident. A tort creditor, unlike a contractual creditor, has not consented to its status. It therefore cannot ex ante adjust to the credit risk of the person who committed the tort.

UNCITRAL: The United Nations Commission on International Trade Law promulgates influential model laws and treaties in insolvency law and related fields.

UNIDROIT: The International Institute for the Unification of Private Law is a treaty organisation that promulgates treaties in private law, including insolvency-related fields.

Universal model: A method of coordinating cross-border insolvency that has one “main” jurisdiction responsible for administering the insolvency and distributing liquidation proceeds (if appropriate), and relegates the “ancillary” jurisdictions to asset collection and other local roles.

Workout: A method of reorganising a firm that does not rely on insolvency law. Workouts employ negotiations between the debtor and (generally) the lead creditors or a committee of creditors. Workouts that readjust the balance sheet of the firm require unanimous consent of all creditors (or full payment of holdout creditors). Successful workouts, therefore, generally only readjust the debt of financial creditors, leaving trade creditors, tax authorities, and the like with full payout.

## **APPENDIX E:**

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