CONTACT GROUP ON THE LEGAL AND INSTITUTIONAL UNDERPINNINGS OF THE INTERNATIONAL FINANCIAL SYSTEM

Insolvency Arrangements and Contract Enforceability

September 2002

Preface

Financial markets deal with the future. As Andrew Crockett, General Manager of the BIS, once remarked, the function of financial claims is to telescope into the present intrinsically uncertain cash flow streams. This "telescoping" is socially beneficial, as it permits risks to be priced, allocated and diversified across the economy. But performing this function smoothly and efficiently entails negotiating, concluding and settling financial contracts, sometimes of great complexity. To this end, there must be mechanisms for ensuring that the rights and obligations specified in the contract are observed, and for dealing with disputes predictably and fairly where they are not.

This is why financial transactions in every country are governed by a corpus of law that specifies the nature of the contract and provides mechanisms for seeking redress in the event of a failure to perform. Each national legislation tries to strike a balance between a plurality of needs which at times may conflict with each other: making the future more predictable; minimising transaction costs; ensuring equity of treatment of the parties involved in the contract. Needless to say, where the balance is struck will depend on many things, from the structure of the economy to legal traditions and political preferences. There is no guarantee that the choices made in each country will form a coherent whole across jurisdictions.

The combination of highly integrated capital markets worldwide and country-based jurisdictions is probably the most notable feature of today's international financial environment. This combination raises three concerns. First, policy-relevant frictions might arise from the diversity (and in some case incompatibility) of national legal systems. Second, there might be a concrete risk of legal arbitrage among jurisdictions, with a loss of predictability in the application of norms and thereby in the actual balance between the different goals that each legal framework tries to reconcile. Third, as a result of financial integration negative externalities (in the form of spillover and contagion effects) might be the consequence of deficiencies or gaps in the legal systems of certain jurisdictions (emerging market countries and offshore centres being obvious examples).

Market practitioners have over the years tried to fill some of the gaps by developing a set of practices, conventions, and customs to reduce the risks associated with international financial transactions. Such a "soft law", however, is unlikely to be an effective response to the needs of a global financial marketplace. In fact, informal conventions or understandings developed in the market, while perhaps efficient for a specific purpose, might have the unintended effect of making the overall legal apparatus presiding over international transactions more opaque, and therefore also less predictable in its application.

Over the past few years, several international financial institutions and other international organisations have launched initiatives in the legal field. In principle, such initiatives can be grouped into two different categories. The first category comprises initiatives that follow a "house-in-order" approach, namely which try to identify the basic building blocks of a satisfactory legal system, leaving to individual countries the responsibility for choosing how to fill the general canvas with the operational details that best fit their domestic context. The second category, by contrast, includes attempts to isolate areas where a kind of "minimal harmonisation" of national practices may be beneficial for the smooth working of the global marketplace. Typical of the latter approach is the drafting of a set of principles and best practices to be offered to emerging-market countries as a contribution towards strengthening their domestic institutional setup. The two approaches are not incompatible, though they are clearly different in scope and ambition. The "house-in-order" approach has attracted greater attention so far, both because removing institutional deficiencies in recipient countries seemed to warrant top priority, and because it was perceived as raising fewer political problems. It is important to recognise, however, that such an approach, while necessary, may not be sufficient to adequately contain the costs and risks associated with the functioning of increasingly integrated financial markets. Moreover, the lack of agreement on what constitutes a satisfactory "minimal harmonisation" may make the "house-in-order" approach more difficult to implement. Given the lack of international enforcement tools, in fact, the adoption of a given set of principles and standards must rest on the perception that, though there is no "one-size-fits-all" legal system, some practices and institutions are clearly better than others.

The time therefore seems ripe for initiatives aimed at:

a) surveying the work undertaken so far by the various IFIs, with the objective of identifying major themes as well as possible gaps and areas of overlap;

b) taking stock of and diffusing the lessons of the recent crisis episodes for the benefit of the reform process now under way in many emerging market countries;

c) deepening the international authorities' knowledge of the "soft law", with a view to assessing its features, potentialities and possible drawbacks;

d) identifying a possible role for international groups, such as the G10 or the G20, in promoting more robust, transparent and mutually consistent legal institutions and practices relating to financial transactions.

In this spirit, in the summer of 2000, on the initiative of the Bank of Italy, the G10 Deputies launched a reflection on the issues raised by the increasing integration of international financial markets, and especially by the emergence of large players whose financial activities span many countries and jurisdictions, for the operation of one important component of the legal system, namely insolvency law. The task was taken up by a Contact Group composed of interested countries and institutions. Participants have included representatives from Italy, Japan, the

Netherlands, the United Kingdom and the United States, as well the BIS, ECB, IMF, OECD and World Bank.

This report is the outcome of that effort. Given its exploratory nature, the report contains no recommendations. It was not submitted to Ministers and Governors for their approval and the analysis and conclusion do not purport to reflect the views of the G10. Its aim is to stimulate interest and further reflection on a policy issue of ever greater significance, rather than to offer firm conclusions regarding the actual magnitude of specific problems or to formulate policy options. The document pursues this aim by identifying current trends in the area of insolvency laws, by discussing some problems created by the growing integration of financial markets, and by pointing to some areas where gaps or frictions seem likely to emerge (or have already emerged). The findings are largely based on two questionnaires: one on national insolvency arrangements and one on the treatment of financial contracts under these insolvency arrangements. The contracts reviewed through the latter questionnaire include closeout netting and setoff provisions, finality rules in payment systems and collateral agreements.

The text has benefited from observations and suggestions by a selected number of interested parties, to which a previous draft had been submitted for comment. The process of consultation has included other authorities in the countries represented in the Contact Group, the central banks and finance ministries in other industrial countries, and various groupings with an interest in the issue.

The report is preceded by a brief executive summary that summarises its main findings and identifies possible avenues for further investigation. Selected contributions by individual members of the Contact Group are also included as annexes.

Executive summary

Insolvency arrangements and contract enforceability

Recent episodes of financial stress (Enron, LTCM, LTCB) demonstrate the importance of having effective means to achieve the rapid, efficient and equitable resolution of troubled and insolvent companies with extensive financial operations. The challenge is made greater by the increasing global reach of ever larger and more complex financial institutions and non-financial firms with substantial financial activities. The rapid evolution of the environment in which insolvencies occur and the more measured evolution of insolvency regimes have created notable tensions and significant pressures for change. Effective resolution techniques are needed for financial institutions and other active financial market participants in order to contain systemic risk, limit moral hazard and reduce the distortions that arise from the existence of the safety net.

This report examines the objectives and operation of insolvency processes (particularly for financial institutions and non-financial firms with substantial financial activities) in countries with well developed economic, financial and legal infrastructures. It was prepared by the Underpinnings Contact Group. It is based on two comprehensive surveys: of insolvency arrangements for financial institutions and financially active non-financial firms and of the treatment of financial contracts under these insolvency arrangements. The contracts include closeout netting and offset provisions, finality rules in payment systems and collateral agreements to support financial transactions.

The report is exploratory in nature. It considers broad trends in financial markets and insolvency procedures and seeks to suggest perspectives and problems worthy of further investigation. Hence, it does not make concrete policy recommendations, but recognises the need for further analysis and research by academics, practitioners and the public sector.

Framework of analysis

How should we evaluate and compare alternative insolvency processes and private workouts? The criteria used in this paper derive from the goals for the design of insolvency arrangements. These goals are (1) reduction of legal and financial uncertainty, (2) promotion of efficiency and (3) provision of fair and equitable treatment. Increased legal certainty helps market participants form a probability distribution around the outcomes of financial transactions, and to make choices based on their willingness to bear risk. The promotion of efficiency involves the alignment of the incentives of managers, creditors, shareholders and other actors in the bankruptcy process. It also involves devising effective means to reduce the risk of moral hazard. Equitable treatment reflects consensus about the relative burdens between debtors and creditors and among creditors in insolvency, expressed in the rules and payment priorities in the insolvency process.

These three objectives are often complementary. For example, a degree of legal certainty is necessary in order to measure efficiency or equity. Similarly, laying out a preordained hierarchy of claims that debtors and creditors know will be observed when liquidating a firm not only establishes relative equity but also increases legal certainty and efficiency in that each class of creditor can expect to be treated consistently and in accordance with expectations when a liquidation occurs. Legal certainty and efficiency, and to some extent equity, contribute to lowering liquidity and systemic risks in that they reduce the potential for market disruption and large deadweight losses.

Yet tensions can and do arise among these three objectives. For example, legal certainty about closeout netting may make parts of the insolvency process quicker and more efficient. But it may also change the effective priority of claimants and thus the equity among creditors in an insolvency.

One outcome, which is almost always consistent with reconciling tensions among the three objectives, is to maximise the value of the bankruptcy estate. Fully realising the value of the firm's assets is consistent with efficiency. Because creditors are repaid according to an established set of priorities, a larger bankruptcy estate also means that no creditor is worse off and some are better off. Resolution approaches that are both speedy and have low transactions and administration costs are generally most effective in preserving the value of the bankruptcy estate and limit spillover effects on third parties through payment and settlement systems or through key financial markets. Thus, in the absence of market failure, maximising the value of a troubled institution should be consistent with minimising the loss to society associated with the episode of stress at that financial institution.

Principal findings

Based on an analysis along these lines, the principal conclusions of the report are:

1. Speedier, market-based insolvency mechanisms appear to better meet the needs of participants in advanced financial markets. These mechanisms, such as the use of auctions and expedited asset sales, are based on the increased capacity to price and sell in markets many components of the company that were previously "firm-specific", that is, specialised to the insolvent firm's activities and sold with difficulty to others. The availability of markets allows creditors to estimate more precisely asset prices and ultimate recoveries. Market-based mechanisms increase efficiency and the bankruptcy estate available to be paid out. This suggests that reforms in insolvency regimes that make them quicker and more market-based could be largely equity-neutral, in that no creditor or stakeholder would be worse off than under current arrangements.

2. Speed in the insolvency process is especially important for credit exposures to insolvent firms in those market segments where risk and liquidity are transferred among large financial market participants. In those markets, disruption could have spillover effects on other market

participants and spread disturbance across the financial system. The reliance by financial institutions and other financially active firms on traditional and innovative financial instruments to manage liquidity and risk is reflected in the huge daily volumes of transactions in key financial markets and in payment and settlement systems. This reliance has augmented the need for legal certainty. In response, legislation at the national level has provided precise finality rules, closeout netting and offset provisions, collateral arrangement and other contractual and statutory provisions that "carve out" some transactions from formal insolvency processes. Carve-outs effectively change the priority of creditors and potentially can make some creditors (eg unsecured creditors) worse off. The widespread adoption of such statutes suggests that, at the national level, the gains in legal certainty and efficiency are seen as large relative to the reduction in equity to any creditors. These gains in certainty and efficiency are largely seen in simplified transaction planning and reduced systemic risk, because these carve-out statutes do not substantially simplify the liquidation process itself, which must still resolve the non-financial assets and liabilities.

3. Additional financial arrangements, notably securitisation and outsourcing, appear to facilitate more efficiency and legal certainty in the insolvency process. Such techniques have the additional feature of reducing the assets and liabilities of the insolvent firm in insolvency. (Outsourcing reduces the true size of the firm; securitisation reduces the firm for insolvency purposes, by recharacterising secured loans as sales.) While such market-driven arrangements may be efficient, they may also have implications for equity by de facto revising creditor priorities in insolvency. The use of these arrangements is occurring with much less explicit legislative consideration of their impact on the insolvency process and how the positions of debtors and creditors are being affected.

4. Differences in national insolvency laws, reflecting national consensus about equity concerns and appropriate insolvency procedures, might create tensions at the international level.

- Creditors and debtors may be able to initiate insolvency proceedings in one of several relevant jurisdictions. In particular, differences exist across jurisdictions in the statutes concerning the enforceability of financial contracts which may complicate their execution in insolvency. Moreover, some jurisdictions permit the liquidation of financial institutions under a single entity approach (where assets are pooled and distributed to all creditors according to priorities set for the whole entity), whilst others adopt a separate entity approach (where certain assets booked to local branches are subject to local jurisdictions, thus taking advantage of or at least highlighting these differences.

- These differences have three effects in common. They increase legal uncertainty, because the jurisdiction and prevailing law and approach can vary as the location and nature of the insolvent firm's assets and activities and as the firm's counterparties vary. Efficiency can be reduced, especially where multiple jurisdictions and conflicting laws make predicting outcomes more difficult and create complex coordination problems. Equity may be impaired, since the debtor or creditor may not receive the treatment and priority that was expected in entering into a financial transaction. Furthermore, the outcome of jurisdictional differences on the single/separate entity approach may not seem equitable to all creditors.

Despite the variety of potential tensions, occasional cross-border insolvencies in recent years have not created substantial disruption. Comity among jurisdictions in the limited number of large failures in recent years has proved helpful in keeping the tensions under control.

Recent developments

Market participants and the official sector are actively working to address specific problems for cross-border insolvencies in those areas in which tensions are most apparent, and substantial progress is being made. Some examples are:

- The European Union has created an approach for coordinating cross-border liquidation of financial institutions: the EU Winding-Up Directive. The innovation in this Directive is that it specifies a unique main insolvency forum, at least for parties within the European Union.
- Recent private international law reform efforts have succeeded (or are progressing) in providing a definite location to cross-border intangible collateral. These efforts include the UNCITRAL Convention on Cross-Border Receivables and the Hague Conference on Private International Law, concerned with interests in securities held through financial intermediaries.
- Within the European Union, a proposed Directive on financial collateral arrangements has just been promulgated. This Directive will provide a special regime for the creation, perfection and enforcement of certain collateral arrangements.

The intention of the above initiatives is not to harmonise the relevant substantive laws but to identify best methods of coordination and extend them Community-wide or worldwide through instruments such as a Directive or Convention.

In a few limited contexts, substantive rules of law have been harmonised, particularly regarding collateral. Examples include the UNIDROIT Mobile Equipment Convention and Aircraft Protocol, and select parts of the UNCITRAL Receivables Convention. UNIDROIT also is beginning a project harmonising the substantive law of securities collateral.

Taken together, these efforts demonstrate that the problems of cross-border insolvency have been recognised broadly in G10 countries and that the industry and the official sector have been able to make significant progress in reducing legal uncertainty, increasing efficiency and improving the ability of market participants to develop probabilities of how claims will be treated under insolvency. Nonetheless, cross-border insolvencies of financial firms and non-financial firms with substantial financial activities will probably continue to rely substantially on comity among jurisdictions and a high degree of cooperation among supervisors, and the insolvency process is likely to remain costly. Clearly, therefore, much further work along the lines of that already under way could be done over time with the encouragement and active participation of financial authorities.

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APPENDICES

I. Introduction

In the recent past, several large, internationally active firms have entered formal insolvency proceedings, among them Drexel, TWA, Barings, Maxwell, Olympia & York, Enron and Global Crossing. Others have come close to doing so, for example Long-Term Capital Management. The asset size of these actual or potential failures is increasing, and with it the risk of a disorderly and contentious outcome.

Since Herstatt, no major financial insolvency has been disorderly, although there have been some close calls. This is due to several contributing factors: a combination of improved risk management, greater transparency, a vastly superior legal framework, international cooperation among authorities, and good luck. This positive history, however, offers few reasons for complacency. The failures to date have been of firms of moderate and intermediate complexity. Firms and markets become ever more complex, more interrelated, and ever larger. An increasingly deregulated market environment is a less cosseted one: greater competition entailing greater risk of failure. Sovereignty remains a fact of life, but business operations are increasingly cross-border, placing greater strain on the legal system.

Therefore, the underpinnings of insolvency law are especially salient for large, complex and internationally active financial institutions, and the Financial Stability Forum has been considering issues in anticipating and managing such problems. Both general and financial firm-specific insolvency regimes are relevant. While the principal operations of such institutions are primarily housed in supervised entities, such as banks and securities firms, significant activities may take place in unsupervised holding companies or affiliates. Furthermore, there are now non-financial companies that undertake financial activities on a scale that approaches those of major financial institutions. These include General Electric and the world's major automobile companies, as well as the recently insolvent Enron. Furthermore, financial firms and markets often have large exposures to non-financial firms, as both creditors and counterparties. Finally, many countries do not have special purpose financial insolvency law, but rather treat bank insolvencies with minor modifications, if any, to their general insolvency system.

This report discusses the insolvency process - particularly that of banks - in countries with well developed economic, financial and legal infrastructures.

A. Role of the Contact Group

To explore these issues, the BIS formed the Contact Group on the legal and institutional underpinnings of the international financial system (the Contact Group). The Contact Group was formed in response to a suggestion at a G10 Deputies meeting by the Bank of Italy. Participation was voluntary. The members are representatives of the European Central Bank, the Bank of Italy, the Bank of Japan, the Netherlands Bank, the Bank of England, the Federal Reserve Bank of New York, the Bank for International Settlements, the International Monetary Fund, the Organisation for Economic Cooperation and Development and the World Bank.

The Contact Group has considered the legal and institutional arrangements for resolving the insolvency of financial institutions and of non-financial institutions that have substantial financial activities. The Contact Group has examined both general insolvency regimes and special regimes applicable to financial insolvency. Some of these financial insolvency regimes are applicable to particular categories of institutions (such as banks and non-financial corporations with significant financial activity). Others apply to a particular type of transaction or operation (such as the taking of collateral, the finality of settlement of transfers of funds or securities and netting transactions). 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.

The Contact Group sought to explore two areas of the legal system of direct relevance for financial transactions: the nature of insolvency proceedings and rules governing contract enforcement in insolvency (including netting and collateral), first at the national level and then at the international level. The effort has involved two stages. Since law and legal rules are based on nationally defined jurisdiction, the Contact Group has conducted two comparative surveys of the legal situation in the jurisdictions represented within the group, namely the European Union, Italy, Japan, the Netherlands, the United Kingdom and the United States. Then, on the basis of the responses to the questionnaires, a number of policy issues have been identified and discussed.

The first survey compared legal and institutional arrangements for insolvency in different jurisdictions (the "insolvency survey"). The second survey compared the effect of insolvency arrangements on the performance of financial contracts (the "contract enforceability survey") in different jurisdictions. Appendix B contains analyses of these surveys.

B. Summary of findings

This report offers reflections on national insolvency regimes and the coordination of an international insolvency based on the results of the questionnaires, a review of academic literature and further analysis. It describes current insolvency law and its context from an economic perspective, and evaluates legal rules governing insolvency by three criteria: efficiency of the insolvency process, equity of treatment and reduction of uncertainty. Using this analysis, the Contact Group has identified two salient issues, discussed in turn in Sections II and III of this Report. It also discusses law reform efforts addressed to these issues, in Section IV.

1. Business environment and insolvency law

The first issue identified is the gap developing between the rapidly changing environment in which insolvencies occur and the slower evolution of national insolvency regimes. These regimes, largely developed in the 19th or early 20th century, have evolved over time. However, they have not kept pace with the dramatic changes in capital markets, globalisation, corporate governance and markets for corporate control, and techniques of financial management. On balance, the gap increases the demand for legal certainty and efficiency on the part of market participants.

Perhaps the most important source of uncertainty and inefficiency lies in the slowness of traditional insolvency processes. Insolvency processes tend to be initiated later than they should be, and to be very slow after their initiation. Both earlier initiation and faster resolution tend to be more efficient; faster resolution decreases legal uncertainty. Late initiation is a problem of incentives. Creditor incentives to initiate insolvency are strong, and creditor initiation is therefore made difficult in insolvency regimes. Debtor initiation is easy, but debtors seldom have incentives to declare early insolvency. Regulatory incentives are blunted, unless the regulator has a direct financial stake, eg as an insurer. Slow resolution is usually inherent in the ordinary legal rules governing insolvency, although some specialised bodies of insolvency law do emphasise speed, especially Japanese and US bank insolvency law.

The demands for legal certainty and efficiency are especially great for risk transfer mechanisms, such as derivatives contracts, which require active management. The development of a body of law on financial contract enforceability - still in the process of being extended and refined - is meant to address these issues. However, because such new law addresses only some of the issues and only some of the assets and liabilities of financial firms, it creates some tension with existing insolvency processes, because in effect it alters the priorities in insolvency. Enhancing the legal certainty and efficiency of the insolvency process beyond the current rules for financial contracts might relieve the tensions, without necessarily changing the equity concepts in national insolvency law.

2. Globalisation

The second issue stems from the increasing globalisation of financial activities and the global scope of financial institutions in a legal environment still defined by national jurisdictions. Sovereign jurisdiction over global activities raises the possibility of **forum shopping**.[*] Forum shopping sometimes creates a healthy competition among jurisdictions. But it can also increase ex ante uncertainty and creates a tendency for the relevant legal rules to be the ones most favourable to the party who can select the insolvency forum. Efficiency can decrease because the administration process can be complex and contentious and it may adversely affect incentives for creditors, debtors and regulators ex ante and ex post. As opposed to the national setting, where improvements in the general insolvency process can at least in concept be equity 00000neutral, in the international setting solutions to multi-jurisdiction issues need analysis of equity questions.

Even without forum shopping, globalisation creates many problems. Some of the problems are strictly legal, such as the uncertain choice-of-law rules governing collateral or netting. Other problems are inherent in the coordination of disparate insolvency proceedings.

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[*] Various technical economic and legal terms, when first introduced, are **boldfaced**. These terms are defined in a glossary, in Appendix D.

3. Law Reform

Many worthwhile insolvency-related reform efforts are already in progress, at both the national and international levels. For example, many jurisdictions are reducing settlement risk by improving their treatment of netting and closeout of financial contracts. Difficult choice-of-law issues are being addressed by international law reform efforts, emanating from organisations such as the European Union, the Hague Conference on Private International Law ("Hague Conference") or the United Nations Conference on International Trade Law (UNCITRAL). As part of this process, two EU directives and an insolvency regulation recently set out an approach for coordination of international insolvency processes that identifies a main insolvency proceeding for financial and non-financial firms within the European Union. Many jurisdictions are streamlining their insolvency procedures, with an eye towards adopting "best practice" from other jurisdictions.

II. Analysis of national insolvency processes

This section discusses insolvency processes of advanced jurisdictions. It is couched at a very general level, and is concerned with the structure and organisation of the processes rather than the specific legal rules associated with them.

It begins with an analytic framework by which to evaluate insolvency processes. The second subsection then describes insolvency processes, both mainstream and innovative. The mainstream processes (piecemeal liquidation and most forms of reorganisation) make some implicit assumptions about capital and related markets, globalisation, dynamism and the distinctiveness of financial services. As discussed in the third subsection, these tacit assumptions, although once probably true, seem outdated today. Some of the innovative processes may better accommodate the new rules of the game. The fourth subsection discusses the special insolvency rules pertinent to financial contracts. The section concludes with a recapitulation of some of the issues, phrased in terms of the analytic framework developed at the beginning of the section.

A. A framework for analysis

The process of resolving a troubled company, no matter whether or not it takes place under a formal insolvency regime, generally involves retrenchment and focusing on viable operations, and closing down or selling off operations that are either unprofitable or ancillary. It commonly also involves a restructuring of liabilities. The basic issues of insolvency can be most easily described in a timeline of financial distress for a firm, as shown in the following diagram[1]:

[1] The timeline of financial distress is adapted and extended from Matthias Kahl, "Economic distress, financial distress, and dynamic liquidation", *Journal of Finance* 62 (February 2002) pp.135-168.

Emerging problems: management-led correction	Acute and worsening problems: private workout	Insolvency: but possible viability: reorganisation	Insolvency and unlikely viability: liquidation

time→

A financial institution or financially active firm that experiences emerging problems - worsening loan quality, losses due to internal control lapses - has the option to develop business plans to address the underlying problems. Many problems are in fact resolved this way. If uncorrected, however, or if some other devastating blow occurs, the firm's difficulties may be severe enough to require a private workout.

A private workout usually involves some restructuring of debt, the possible issuance of additional equity, and sales of assets or businesses. Traditionally, a firm's "main bank" could pressure a liquidity-constrained firm to enter a workout, and in many cases where creditors rely primarily on a 'main bank', the ability of banks to encourage workouts persists. In the case of large, internationally active financial institutions and financially active firms, no one creditor has sufficient influence. But increasingly, far-seeing managements recognise the need for restructuring and initiate management-led private workouts in order to realise the maximum long-run value of the firm for shareholders. A notable example was the successful extensive restructuring of IBM in the early 1990s; currently many financially strong telecommunications companies are restructuring in the light of the industry's present overcapacity.

As the firm moves closer towards or into insolvency, it may seek to reorganise through an insolvency law procedure. Most frequently, management initiates such an insolvency reorganisation. A reorganisation gives management time and powers to restructure an insolvent firm as a going concern, effectively offering it a second chance to make the firm successful. If a firm is viable and can be turned around, a reorganisation benefits many creditors if the overall losses are lower than in a liquidation. If creditors are uncertain about the viability of the firm, they may still look favourably on reorganisation as a means of developing further information about the firm's viability.

Finally, usually either the creditors or the debtors can initiate a liquidation process if the legal condition(s) for insolvency is (are) satisfied. An important exception is banks and some other financial firms, where, in some jurisdictions, only the regulator or insurer can initiate insolvency.

The entire timeline can be viewed as steps in a process of "dynamic liquidation"[2] - firms may recover and exit the process, they may work their way through the entire process through a series of business disappointments, or they may leap to the final stage of liquidation. At each stage the firm traverses, the existence of the statutory possibility of liquidation provides an incentive for debtors and creditors to cooperate in private workouts and reorganisations, which thus take place "in the shadow of the law". The extent to which formal insolvency procedures are debtor or creditor friendly affects the amount and nature of the risk that borrowers are prepared to take and the terms and conditions on which lenders are prepared to provide money.

The statutory frameworks dealing with insolvency can be explained by three underlying objectives of insolvency regimes: the reduction of legal and financial uncertainty, economic efficiency and the fostering of equitable treatment. Legal certainty and efficiency, and to some extent equity, contribute to lowering liquidity and systemic risks in that they reduce the potential for market disruption and large **deadweight losses**. The three dimensions are not strictly speaking mutually exclusive, but are relatively separate and intuitively appealing. Despite their overlap, some tension between them is inevitable. Each national legal framework tries to strike a balance between them on the basis of local preferences and tradition.

Legal uncertainty affects the ability of market participants to form a probability distribution around the outcomes of financial transactions. If legal uncertainty is too great, market participants cannot assess the risks in entering into contracts. In such circumstances, it may be very difficult to talk meaningfully about the efficiency or the equity of an insolvency regime. If legal uncertainty is sufficiently low, but not necessarily very low, market participants can estimate the probability of possible outcomes and make choices based in part on their willingness to bear risk. Reductions in legal uncertainty, therefore, generally represent an improvement for debtors, creditors and other stakeholders. Nonetheless, the benefits from increased legal certainty need to be weighed against any negative impact on efficiency or equity associated with the rules used to enhance legal certainty.

An improvement in economic efficiency can be achieved chiefly in three ways. One is aligning incentives for all parties to a transaction to maximise the long-run value of their respective firms and reducing incentives to waste resources in order to avoid the consequences of failure on the firm's management or owners. In general, incentives that align actions with market outcomes are seen as improving efficiency (except in markets where market failure is inherent). A second is reducing the transaction costs involved in the insolvency process, especially deadweight cost. Finally, efficiency is improved by any other means that increases the total amount of wealth of all the parties in the insolvency, eg., rules or practices that preserve the value of **firm-specific assets** or increase information available to the parties.

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[2] This extends the concept set out by Kahl in the article cited in footnote 1 to describe the relationship between reorganisation and liquidation.

Issues of equity by their nature involve value judgments. In the case of insolvency law, that judgment has already been made in national laws and accepted practices which define the rights of debtors and the rights and relative priority of creditors and other stakeholders. Some jurisdictions seem more "debtor-friendly," in that they give management more opportunity and ability to protect the value of the firm's assets; others seem more "creditor-friendly" in that creditors (especially secured creditors) have greater ability to initiate and control an insolvency process or realise their collateral in order to maximise recoveries from the debtor's estate.

In the insolvency context, a fairly conservative standard of determining improving outcomes seems to work well. That standard is that one outcome is better than another if anyone is better off and no one is worse off in the first outcome than they are in the second, which economists call **Pareto superiority**. This standard works well since insolvency laws assign the order in which claims are paid and generally all claims of senior creditors are satisfied before the claims of more subordinate creditors are paid. Thus, if the insolvency estate is larger in one situation than another,[3] and the pre-existing debtor-friendliness and priority of claims is maintained, some creditors will receive more and all creditors will receive at least as much in the first situation as in the second.

B. The processes

1. The basic processes: workouts, liquidations, reorganisations and others

Insolvency law and practice have evolved through accretion of experience. Much of this experience has been national, adapted to a particular jurisdiction's unique traditions and social needs. But despite the diversity of insolvency law and practice, some common themes apply to all jurisdictions. All business insolvency laws must face the same problem: resolving the competing claims of stakeholders when the debtor firm may not have sufficient resources to satisfy all claims on time and in full.

Insolvency law has two traditional solutions to this problem: the "**liquidation**" and the "**composition**" (or "**reorganisation"**.) There are many traditional solutions outside insolvency law, of which the "**workout"** is most significant. A liquidation converts the insolvent entity's assets into cash, and distributes the proceeds to claimants. A composition or reorganisation seeks to preserve the entity and readjust the claims of stakeholders so that the entity can successfully meet the readjusted claims. A workout is similar to a composition or reorganisation, but proceeds outside insolvency law. A liquidation often serves as the backstop to an unsuccessful

[3] Technically, it is not the absolute size of the insolvency estate that is relevant, but instead the size of the estate minus the size of the claims. This distinction is particularly significant with asset securitisations and netting arrangements. Both devices decrease both the size of the estate and the number of claims against the estate, and may well be Pareto-superior. For simplicity, this report refers to "size of the estate."

reorganisation or composition. A reorganisation, in turn, often serves as the backstop to an unsuccessful workout.

To introduce various processes for dealing with financial distress, we shall begin with the classic distinction between liquidation and reorganisation. For our purposes, a liquidation acts on the *assets* side of the balance sheet. A liquidation has two steps: reducing the insolvent firm's assets (or business lines) to money, and then distributing the proceeds to creditors, in accordance with priority rules. As a result, the firm ceases to exist as an entity, although its business may be carried on by those who acquire its assets. A reorganisation, in contrast, preserves the firm as an entity. A reorganisation may affect assets, but operates on the *liabilities* side of the balance sheet. A reorganisation temporarily postpones liabilities, and uses the time gained to readjust the claims on a firm so that they correspond better to the firm's value and expected cash flows. A reorganisation does not necessarily affect the assets side, although asset and business line sales are common in reorganisations.

Liquidations often disrupt the going-concern value of an insolvent firm, but need not do so. In principle, the whole firm can be liquidated as a unit, preserving its economic value, albeit perhaps at distressed prices. But as is often the case, the troubled firm may not have much of a going-concern value or a **bulk liquidation** may be otherwise infeasible. In such cases, a **piecemeal liquidation** may be preferable, yielding a higher return to creditors, or at least a quicker return.[4]

Reorganisations are more complex, and may be divided into a number of categories. The most traditional category of reorganisation - the "composition" - is typically consensual, although some compositions may permit majorities to bind minorities.[5] In this process, the creditors negotiate with each other (and generally the debtor) to readjust the relative stakes in the organisation. The composition therefore resembles a debt workout, although it is generally aided by a court-imposed moratorium on debt collection procedures. Compositions suffer from most of the same weaknesses as sovereign debt workouts, and succeed - if they do - for the same reason: solidarity among creditors. This solidarity is achieved by use of creditors' committees composed of major creditors, and the common practice of paying many minor creditors (eg trade creditors) in full.

Nevertheless, compositions are at risk of holdout. Another class of reorganisation lowers this risk considerably. Such reorganisations generally resemble negotiated compositions. But if the negotiations fail, these reorganisations allow for substantive judicial intervention: binding holdouts who resist an appropriate majority of their class of creditors, or even imposing a new

[4] One negative externality of piecemeal liquidations of banks is worth mentioning in margin. A piecemeal liquidation may reduce the availability of credit to smaller borrowers. These borrowers are forced to repay the insolvent's estate, but often cannot find replacement credit, because their credit information is lost in the liquidation proceeding. Although competition assures that this problem is usually temporary, it may be lethal to some otherwise viable small businesses.

[5] The old German Composition Code, for example, permitted a 75-80% majority to bind a minority. This was repealed on 01 January 1999.

capital structure on the firm if negotiations fail ("**cram-down**"). We shall call these reorganisations "**Chapter 11-style reorganisations**", because they were popularised in Chapter 11 of the United States Bankruptcy Code. For most purposes, this report will not distinguish between compositions and Chapter 11-style reorganisations, because the similarities between these two techniques far outweigh the differences. Indeed, many jurisdictions use various hybrids of the techniques discussed here.[6]

Indeed, the debt workout, the composition and Chapter 11-style reorganisation can all be viewed as part of a continuum. They all rely on negotiation between the debtor and creditors. All of them risk failure from holdout problems. In a bilateral workout (which is common for small firms with a single bank creditor), the holdout risk is between debtor and creditor. The more complex reorganisations share this risk, but also risk holdout by a minority of creditors. To cope with this problem, these different reorganisation processes employ different mechanisms of creditor solidarity. The workout uses a purely private mechanism: limiting the creditor class by excluding numerous (but low-value) creditors such as employees or trade creditors. These creditors are usually paid in full notwithstanding any formal parity between their claims and the claims of the financial creditors. (In some jurisdictions, their claims would have priority in any case.) Nevertheless, despite assuming an inferior position, financial creditors negotiate because negotiation is better than the alternatives: liquidation or a rush for assets. The other proceedings tend to mirror this approach (weak creditors do not negotiate but are often paid in full), but add additional techniques. The composition adds a judicial moratorium on debt collection. This increases creditor solidarity by precluding a rush for assets, leaving liquidation or negotiation as the sole alternatives. The Chapter 11-style reorganisation retains this moratorium, and contains a cram-down. Some variations of this procedure allow for an insolvency official to create its own reorganisation, if the parties cannot negotiate their way to one.

The **liability transfer** is very different from reorganisations, but leads to the same result: a transformed balance sheet. In this technique, an insolvency official (or court) assigns the old liabilities, and often, some portion of the old assets, to a solvent organisation. Liability transfers are particularly useful when the liabilities are contingent (eg. insurance or letter-of-credit liabilities), when the liabilities themselves are vested with going-concern value (eg a consumer bank deposit with appreciable switching costs), or when the liability structure is well-suited to the assets it supports (inexpensive funding or effective maturity matching). A liability transfer results in a restructured balance sheet, without the need for negotiations.

There are several kinds of liability transfers. We begin with the simple **merger**. A distressed firm may be purchased by another firm with a stronger balance sheet, transferring the assets and

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[6] For example, in the United Kingdom the reorganisation resembles a composition in some respects: lack of cram-down and moratorium on debt collection or liquidation of collateral. However, it does not contain a continuing role for existing management, and is less negotiation-intensive than either a classical composition or a Chapter 11-style reorganisation.

liabilities of the old firm into the new one. (Mergers are very common in declining industries that need to restructure and in dynamic industries in which comparative advantage shifts rapidly.) The merger is a private transaction that only works when a distressed firm has some net going-concern value, or has powerful synergies with its acquirer. However, other kinds of liability transfers, which involve public law, may be used with insolvent firms in general. The "bridge bank" technique used in US bank insolvency law is akin to a merger, but only a subset of the distressed firm's assets and liabilities are transferred into the bridge bank. The rest of the balance sheet remains behind, and is conventionally liquidated. A bank regulator or liquidator decides which assets are transferred, and which remain behind. Or in some cases (the "liability-based restructurings" of insurance law), individual assets and liabilities are transferred to a buyer, without a bridge institution.

As a final alternative, an insolvent firm may be reorganised with public funds. The public funds may either facilitate an otherwise uneconomic merger, or may recapitalise the firm so that it can exist as a stand alone entity. This method can always be exercised by a specific legislative appropriation of funds, but is subject to formal legal regulation only in Japan and the United States (which impose highly restrictive conditions). Because of its intended relative rarity, we do not analyse this alternative in this report.

2. Distinctions among the traditional processes

As discussed above, many of the differences between liquidations and reorganisations are self-evident. Liquidations conform to the statutory distribution scheme; reorganisations typically treat different classes of creditors in very different ways, depending on their negotiating strength and holdout power. The distribution of rights and powers affects the efficiency of the process, in terms of costs, incentives and the amount of post-insolvency wealth.

One important distinction is the respective role of the creditors and the person charged with the liquidation or reorganisation (eg an insolvency "**Official**" - sometimes called an administrator, liquidator, trustee or receiver - or a court). In a liquidation, the creditors do not act collectively, except perhaps to appoint, monitor, or receive information from the Official. Disputes are bilateral ones, between the Official and individual creditors on the one hand, and the Official and the debtors of the insolvent, on the other. In many reorganisations, the creditors are active, often acting collectively through creditors' committees. In these reorganisations, the court's (or perhaps Official's) role is less central, and is not always necessary (as is the case for some compositions). This leads to a useful distinction: that between a **stakeholder-centred** and an **Official-centred** insolvency process.

As a general rule, the Official-centred model tends to be dominant in liquidations and liability transfers, including many bank insolvency proceedings. The Official-centred model is also a norm in many jurisdictions' reorganisation procedures. Traditional compositions and Chapter 11-style reorganisations tend to be stakeholder-centred. In such proceedings, 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.

This discussion is summarised in the Table 1:

Table 1

	Liquidations	Reorganisations
Official-centred	• Conventional and bank liquidations	• A speciality of bank insolvency law • Sometimes seen in Chapter 11-style reorganisations • Characteristic of traditional European reorganisation proceedings
Stakeholder-centred	• In conventional liquidations, only seen in governance, ie the reporting relation of the Official.	• Workouts • Conventional compositions • Explains most aspects of Chapter 11-style reorganisations

The structure of insolvencies affects the degree of legal certainty. The negotiated stakeholder-centred processes are inherently unpredictable both as to timing and as to outcome. Insolvency negotiations are slow. The outcome of negotiations is ex ante indeterminate, depending in part on the relative skills of the negotiators, in part on the holdout power of the negotiators, and in part on uncertainty in asset and liability valuation. Official-centred processes vary. Some of them - eg liquidations - are relatively determinate, with claimants' entitlements depending on the asset value of the firm and relatively predictable legal rules regarding the priority of claims. Some Official-centred reorganisations can be slower and more indeterminate than stakeholder-centred processes. Others eg US Official-centred bank insolvency proceedings) can be extremely fast, with relatively determinate distributions.

With respect to the nature of the process and its transaction costs, traditional liquidations and reorganisations have several common elements.

Both processes are highly lawyered, even in jurisdictions that use accountants as the primary insolvency professionals. Liquidations might involve a substantial amount of litigation, because debtors of insolvent firms often refuse to pay their debts voluntarily. They see little reputational cost to doing so, expect no ongoing relationship with the insolvent entity, and are likely to settle only after litigation. Also, the Official may well press claims - such as avoidances of preferential or fraudulent transactions - that did not exist prior to insolvency. There is yet more litigation on the liabilities side: the Official is likely to dispute claims, especially contingent claims or undersecured claims, which may involve valuation of the security interest.

Reorganisations may require less litigation (at least of the claims collection variety), but require a great deal of negotiation. (Chapter 11-style reorganisation negotiations typically occur in the shadow of litigation, because an insolvency court must ultimately decide, if the stakeholders cannot agree among themselves.) And reorganisations are prone to their own litigation, especially that of undersecured creditors (who will argue valuation) and others who try to escape the proceeding entirely.[7]

As a result, these processes are usually slow. Some insolvency processes are inherently very slow because of the nature of the insolvent firm's balance sheet. An insurance liquidation, for example, must take a long time because of the large number of long-tail contingent liabilities on an insurer's balance sheet.[8] Similarly, real estate often takes a long time to liquidate, prolonging the liquidation of any firm with appreciable real estate on its books. Asset collections are often slowed by litigation, and the liquidator can be swamped by details so that insolvency processes can be slow even for firms with few contingent liabilities and liquid or short-term assets.

Stakeholder-centred reorganisations are inherently slow because the necessary negotiations are complex, and any adjudication can be even more complex. Also, some parties to the negotiation - especially junior claims such as subordinated debt and equity - tend to benefit from holding out. Junior creditors have an effective option on the firm during the pendency of the negotiation process. They will benefit if the firm increases in value during this process, and are unlikely to lose much if the firm decreases in value. The value of this option increases with time: an incentive to delay. As discussed above, Official-centred reorganisations can vary tremendously in speed, from extremely rapid to extremely slow.

Finally, both Official and stakeholder-centred processes typically suffer from serious governance problems, albeit of different kinds, which reduce efficiency. The governance problems of Official-centred processes are inherent in the protracted complex multilateral negotiations that are central to the processes. Official-centred processes do not have notably high negotiation costs, but suffer from agency costs associated with administration. Private Officials are fee-charging professionals, hired by a creditors' committee or a court; public Officials may have their own agency costs. Adequate incentives may not be place to ensure sufficient monitoring by creditors

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7 The scope of an insolvency proceeding can be hotly contested, largely because of past transactions. An insolvency Official will seek to characterise these transactions as still open under insolvency principles, such as those based on preferences or fraudulent transactions; the counterparties will seek to characterise them as final and not subject to insolvency.

8 Thanks to closeout netting, banks' balance sheets do not suffer from this problem, notwithstanding the long-term contingent nature of many derivatives contracts. The major concern for banks is with standby letters of credit and other independent bank guarantees, which generally expire within a few years of issuance.

or courts.[9] Similar agency costs attend stakeholder-centred processes, with their creditors' committees represented by professionals.

However, the most significant governance problem of any of these processes probably arises from their initiation, rather than their administration. By general consensus, insolvency procedures tend to be initiated too late. Too often, reorganisations do not result in profitable restructured firms.[10] In principle, if a liquidation is initiated at the moment of balance sheet insolvency, creditors should receive 100%, net of their administrative costs. In practice, the yield on liquidations is substantially less for banks, and far less for non-financial firms.

Insolvencies are often initiated by the debtor. The debtor owes its loyalty to the equity holders, who - as residual stakeholders - have only to gain by delaying insolvency in hope of resurrection. (For much the same reason, the management of a weak firm would prefer high-variance strategies, even if they have a negative net present value.)[11] Different jurisdictions have different strategies for reducing this problem. Some insolvency systems punish the management of insolvent firms, eg through management liability for insolvency, or for trading after insolvency. This may work in some cases, but gives management a powerful incentive to conceal insolvency in others. Chapter 11-style reorganisations favour the carrot, rather than the stick, and give incumbent management a major role in the reorganisation. However, as discussed in margin above, Chapter 11 reorganisations are probably not timely initiated, either.

Creditors do not have the same incentives for late initiation. Indeed, their incentives would be for initiating insolvency proceedings at the earliest possible time. However, creditors face two handicaps in initiating insolvency. First, they usually have less information on the firm's condition than the debtor. Second, they cannot immediately initiate insolvency when they suspect the firm is troubled: they must generally wait for a violation of loan covenants or a failure to make timely payment. Debtors will often not accept loan covenants with hair triggers, and even if they do, violations may not be readily apparent. Also, some legal systems are solicitous of possible strategic behaviour by a creditor. A creditor - especially one without an ongoing relationship with the firm - might wish to initiate insolvency for reasons completely unrelated to the prospects of the debtor firm, eg to escape an unfavourable change in interest rates. Therefore,

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9 In one recent international 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. This case is certainly not typical, but is illustrative. For a perhaps more typical example, see "Creditors fear fees tied to bankruptcy of global", *The New York Times,* 13 April 2002, p B1.

10 Depending on the metric, somewhere between a fifth and a third of US Chapter 11 plans fail. Put another way, the average reorganisation produced firms that showed no profits. See Lynn M LoPucki and Joseph W Dougherty, "The failure of public company bankruptcies in Delaware and New York revisited", *Vanderbilt Law Review* (forthcoming), at http://www.law.ucla.edu/erg/pubs/Lopucki-DelawareRefilings-20020308.pdf

11 Michael Jensen and William Meckling, "Theory of the firm: managerial behavior, agency costs and capital structure", 3 *Journal of Financial Economics* 305 (1976).

the insolvency laws of some jurisdictions make creditor initiation ("involuntary insolvency") more difficult and linked to more objective evidence.[12]

Bank insolvency law contains a third alternative: initiation by a neutral governmental official. In principle, governmental officials - especially supervisors - could have the correct mixture of information and incentives for timely insolvency initiation. But also in principle, timely initiation implies that creditors get paid in full. It is hard to escape the conclusion that even bank supervisors are in some instances too slow in initiating insolvency. Even bank supervisors are hindered, by limited information, bureaucratic inertia, political pressure, risk aversion and perhaps a reluctance to declare their pre-insolvency rehabilitation efforts a failure. However, they may be less imperfect than other parties, especially if the bank supervisor is also a bank insurer, and has a direct financial incentive to initiate timely insolvency.

3. National approaches to insolvency processes

A few of the approaches to insolvency discussed above are universally available in the surveyed jurisdictions. All jurisdictions surveyed permit mergers and workouts, as matters of private law outside formal insolvency proceedings. Similarly universal is the piecemeal liquidation. Reorganisations and compositions of some kind are in fact universal.

Table 2 summarises a survey by the Contact Group.[13] In the table "UK" refers to the law of England and Wales, and "US" law is an amalgam of federal law, New York State law and the Official Text of the Uniform Commercial Code.

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[12] The title of one article describing US law is instructive: Brad R Godshall and Peter M Gilhuly, "The involuntary bankruptcy petition: the world's worst debt collection device?", 53 *The Business Lawyer* 1315 (1998). Other jurisdictions are more creditor-friendly, eg that of England and Wales.

[13] The survey results are in Appendix B.

Table 2

	IT	JP	NL	UK	US
General liquidation	Y	2	Y	Y	Y
General composition	Y	Y	Y	2	N
General Ch 11 reorg	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.

** Not controlled by legislation, but available through the political process.

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

As shown in Table 2 some insolvency processes are less universal than others. Bank liability transfers, for example, have no equivalent in general insolvency law.

Interestingly, many jurisdictions have several classes of specialised proceedings. Bank and insurance proceedings are frequently specialised, but there are also specialised distinctions within general insolvency law, based on criteria such as size or significance. These distinctions are understandable: the liquidation of a large public corporation will be very different from the liquidation of a small shop. Some of these specialised proceedings are obsolete or used infrequently; some are fairly common.

4. Bank insolvency law

The insolvency survey shows that countries have chosen different approaches to the treatment of insolvent banks.[14] Some jurisdictions (eg the United Kingdom and, to some extent, the Netherlands) treat bank insolvency similarly or identically to ordinary insolvency. Other jurisdictions appear to have very distinct legal regimes governing bank insolvency, particularly the United States, Italy, and Japan. In some of these jurisdictions, the insolvency of credit institutions is regulated in the banking laws as a specific subset of insolvency rules, which may be

[14] See Appendix B.

supplemented by general provisions applicable to all insolvency cases in the jurisdiction in question.

There is one universal distinction between bank and ordinary insolvency. In the insolvency law of any of these jurisdictions, a bank regulator can initiate a bank insolvency proceeding, whether it is conducted under general or specialised insolvency law. However, if we look to trends, rather than universals, another distinction appears.

The slower kinds of proceedings - especially the stakeholder-centred ones - are disfavoured in bank insolvency law and the existing faster options - liquidations, mergers and liability transfers - are the norm.[15] Chapter 11-style reorganisations appear disfavoured in bank insolvency law, and compositions seem extremely rare or nonexistent. One reason may be that de facto bank reorganisations often take the form of bank supervisor-overseen (or -encouraged) workouts, outside any formal insolvency process, or with the formal approval of an insolvency court as the last step. In concept, however, there is no reason why procedures for an expedited stakeholder centred approach could not be developed. Forced mergers are common, even in jurisdictions whose bank insolvency procedures differ little from conventional insolvency procedures. Some jurisdictions (the United States and Japan) rely on the most activist procedure of all: the liability transfer. These fast proceedings often have supervisory involvement.

There may be several reasons for these distinctions in insolvency process between banks and non-financial firms.

Liquidity (and systemic risk) is almost certainly the most important of these reasons. Prolonged bank insolvency procedures destroy liquidity: either the liquidity of counterparties or that of markets. This raises the spectre of systemic risk through the very pendency of the insolvency process. Systemic risk creates a powerful need for rapid insolvency proceedings, deposit insurance, or both. Rapid insolvency proceedings - be they liquidations, recapitalisations or liability transfers - are best conducted by an activist Official.

It should be noted that bank reorganisation techniques that call for general moratoriums are particularly inappropriate to modern banking’s need for liquidity. Moratoriums inherently block the payment stream, and for derivatives and foreign exchange contracts may be difficult to implement given that contracts can fluctuate from in-the-money to out-of-the-money and back again. Such moratoriums are also hard to reconcile with the needs of households and small business depositors and borrowers. Moratoriums have their necessary place in bank liquidations - they stop the run on the bank - but are singularly ill-suited to bank reorganisations.

Pervasive supervision may be significant. As discussed above, supervisory intervention, conducted well before the appearance of obvious financial distress, can be a good substitute for

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[15] This is in contrast to insurance insolvency law, which often proceeds extraordinarily slowly, in large part because of long-tail contingent insurance liabilities.

rehabilitation. Regulation also plays a significant role in legitimising activist insolvency procedures, such as a liability transfer or overt government funding. Concerns about administrative intervention in the economy tend to be muted in the financial services sector.

Firm-specific assets, other than human capital, are less common in modern banks, as the loan book of a bank becomes increasingly transparent, thanks to the syndication and bond markets, and a widespread market for credit information. (This trend is still limited by close bank-firm relationships in some countries.) This greater transparency aids rapid sale of particular components of the balance sheet or particular operations. It also makes the liquidation of a bank as a whole easier, thus strengthening the case for liquidation, especially if a supervisor-overseen or encouraged workout has been unable to conserve going-concern value. (However, piecemeal liquidation will dissipate firm-specific human capital.) Finally, it argues that insolvency moratoriums should not apply to security interests in bank collateral. A moratorium is justifiable if the security interest is in a firm-specific-asset, such as machinery. Rapid foreclosure of such a security interest would destroy value. However, a moratorium is much more difficult to justify if the security interest is in a non-firm specific asset, such as most receivables and almost all securities. (The traditional justification for extending the moratorium to non firm-specific assets is that it serves as a temporary loan to the insolvent reorganisation. This justification implicitly assumes that no outside capital will be available to the insolvent firm: an assumption belied by modern capital markets and an active market in post-insolvency lending, such as debtor-in-possession financing.)

Bank creditors, at least traditionally, have been dispersed and weak. The governance problems of creditors' committees - always an issue in insolvency law - would be particularly pronounced in a bank insolvency. This problem is dispelled by supervisor-led proceedings, some of which place the supervisor in the role of an Official.

C. What has changed?

The basic framework of mainstream insolvency law had become established by the 19th century. The most significant advances in the 20th century were probably the Chapter 11-style reorganisation (inspired by procedures developed on pre-war US railroad insolvencies) and the "ancillary proceeding" of international insolvency law (developed in the wake of the Herstatt insolvency).[16] The elements of this framework were probably well-suited to the conditions in which they were established.[17] But do they equally fit the conditions of today?

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[16] Kurt H. Nadelmann, "Rehabilitating international bankruptcy law: lessons taught by Herstatt & Company", 52 *New York University Law Review 1* (1977).

[17] The discussion in the main text assumes that the conditions that formed modern insolvency law were exclusively economic. This is certainly too narrow a view: political considerations played a role. 19th-century insolvency law was shaped by 19th-century classical liberal political theory. This law stressed the quick and orderly resolution of the insolvent and the pro rata satisfaction of unsecured creditors from the assets of the estate. The main alternative

Many observers have highlighted the weaknesses of insolvency law, both for banks and for general firms. Much of the criticism centres around reorganisations or compositions, slow, costly and frequently ineffective.[18] Banks do not usually share these problems, because their reorganisations follow a different pattern: led or encouraged by supervisors and occurring before financial distress becomes public and forces the bank into insolvency. But bank liquidations often share the same problem as general firm liquidations: they are slow, costly and destructive of going-concern value.

This subsection argues that discontent with insolvency law is related to its age. The global financial system has evolved substantially in the last 20 years and the insolvency process has not kept pace. Apart from cross-border issues, the mainstream insolvency process has not responded to this evolution. International law reform efforts are plentiful, but innovation is largely in settlement risk reduction and the resolution of cross-border issues. Procedural reform efforts have been largely confined to adoption of Chapter 11-style reorganisations in jurisdictions without them. This adoption process will substantially improve the insolvency procedures of these jurisdictions. Nonetheless, the Chapter 11-style reorganisations have themselves been subject to criticism, as insufficiently responsive to market developments of the last few decades. Interestingly, most of these criticisms have come from the United States, the birthplace of the Chapter 11 process.

This subsection examines developments in rough order of their significance to insolvency: transformed financial markets, globalisation, a greater need for speed, and an increasing overlap of the banking and general sectors of the economy.

1. Financial, capital and managerial markets

The case for reorganisation proceedings is based on market incompleteness and, to some extent, market failure. If capital and managerial markets were complete and perfect, outside capital could simply purchase and operate all of the insolvent firm's assets, with the purchase proceeds distributed among the liability holders, after satisfying the claims of the secured parties. This would preserve the entire going-concern value of the insolvent firm, with minimal transaction costs and delay.

Of course, capital and managerial markets are not complete or perfect. Economic theory suggests that firms exist to coordinate the production of goods and services where markets do not provide that coordination. This suggests that a firm provides an **externality** in providing its output, which

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to the classical liquidation was the composition, which - consistently with classical liberalism - placed party autonomy at its centre. In the 20th century - particularly the latter part of the century - debtor protection and various social considerations became increasingly important: hence the trends toward weakening the security interest, creating wage priorities, and preservation of the debtor's enterprise. This Report does not speculate on the current political underpinnings of insolvency law reform, but merely notes that they are likely to be significant.

[18] See footnote 10 above.

is lost in the event of its failure - this is a motivation for giving priority to the rehabilitation of the firm in reorganisation.

However, the scope of markets has expanded dramatically, the information set available to participants has increased in both quantity and timeliness, and the functioning of markets has improved tremendously over the last 20 years or so. Inevitably, better functioning markets make assets less firm-specific, even if the assets themselves might be more difficult to evaluate.

First, the depth and liquidity of financial markets in general have increased, for several reasons. Transaction costs and risks of exchanging financial assets have decreased: a result of deregulation, improving technology and legal reform. The scale of financial firms and the growth of the institutional investor sector have brought more risk-bearing capacity to markets. Several jurisdictions have removed product segmentation among different classes of financial firms - further augmenting potential market-making capacity. Improvements in market liquidity and infrastructure have been particularly notable in the equity markets, and the ability of firms to raise equity capital at all stages of their life cycle improved notably. Activity in financial markets has expanded as transactions have shifted from banking to securities markets and as new products have developed to trade risk and assets. For example, low-transaction cost risk transfer products have developed in markets as diverse as pure credit risk and reinsurance.

Second, the depth and liquidity of markets for non-financial assets, both tangible and intangible, have increased: notably the market for firms (or business lines), and the related market for corporate control. The market infrastructure for takeovers is sufficiently strong that the market is limited only by the anti-takeover provisions of some jurisdictions' corporate law. Firms and business lines are frequently auctioned. The availability of merchant banking and institutional investment capital has made even the largest firms potential candidates for acquisition or restructuring, and the market seems to provide adequate information on targets. Furthermore, the market for managerial skills is becoming increasingly sophisticated. Lateral hiring of top executives is a routine matter these days, facilitated by consulting firms (a good source of non-firm-specific top managerial talent) and headhunter firms, which act as brokerages.

Third, in a development particularly significant for insolvency processes, the market for distressed financial and non-financial assets has developed and expanded dramatically over the last two decades, at least in some countries. Specialist investors - such as vulture funds, and firms that specialise in restructuring and remarketing the assets of troubled firms - have created a market in which distressed assets can be priced and transferred at reasonable transaction costs and reasonable speed. The markets for distressed assets rely on the wider array of markets in financial and non-financial assets for the eventual resale of recovering or restructured assets.

Insights from the corporate finance literature into the boundaries of firms (what activities occur inside the firm rather than in markets) have further weakened the case for reorganisation.[19] This literature often focuses on the problem of aligning incentives to produce goods and services, and the role of firm-internal decision-making, coordination and control mechanisms in that process. However, evolving corporate practices have highlighted the important role of sophisticated contracts in solving such incentive problems, aided by modern information technology. The widespread use of outsourcing, as well as the increased use of joint ventures and business alliances, suggest that the scope for rapid restructuring and disposition of assets has increased substantially.

In summary, most arguments for traditional insolvency reorganisation rely on the firm-specificity of management, assets and capital. If management, assets and capital are sufficiently firm-specific, any restructuring of the firm must rely on the firm's internal resources eg through reorganisation proceedings. If outside help is not possible, the firm must rely on its incumbent management, and liabilities must be restructured to fit the firms' assets and cash flows. But if outside markets can provide adequate capital and management to distressed firms or absorb these firms whole or piecemeal, the case for reorganisation or a highly administered liquidation process weakens. Liabilities need not be restructured when an outsider can buy the firm and pay off the liabilities in priority rank.

Although the case for traditional reorganisation has been weakened with time, it may still be valid, at least in some cases, and perhaps many cases. Small non-financial firms cannot yet take full advantage of modern capital and management markets, and only certain sectors of the labour market are becoming less firm-specific. Of course, the smallest firms are usually resolved informally in bank workouts, and reorganisations are reserved for firms with disparate stakeholders. But there are many firms in the middle, and even the largest firms have many specific assets, apart from team human capital. Moreover, as discussed in the framework section, many creditors may actually prefer reorganisation if the viability of the firm is uncertain and more information is needed to decide on bankruptcy.[20] We cannot conclude that reorganisation is obsolete; merely that it is no longer reflective of modern trends.

2. Globalisation

Law is promulgated by sovereign states, and affects those within the jurisdiction of those states. At one time, most firms could be attributed to a single jurisdiction, as could their acts. However, this is increasingly less true for modern firms, which have become international in both their physical presence and the geographical scope of their activities. Furthermore, the markets in

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[19] See for example Oliver Williamson, "The economic institutions of capitalism" (1985); Oliver Hart, Philippe Aghion and John Moore, "The economics of bankruptcy reform", *Journal of Law, Economics and Organisation* 8(3) (l992).

[20] See text accompanying footnotes 1 and 2 above.

which firms operate are becoming increasingly international. Finally, more economically significant acts are intangible, and thus difficult to accommodate to territorially-based jurisdictions. General business law is strongly affected by globalisation, as witnessed by the accelerating output of UNCITRAL Conventions and Model Laws. As with general business law, so with insolvency law.

As larger financial firms have become global in the last few decades, their business and management structure has evolved substantially. Extensive work by the Joint Forum, the organisation of banking, securities and insurance supervisors, documents several relevant features of many global financial conglomerates.[21] First, such conglomerates organise and conduct their business lines to operate across legal jurisdiction and geographical lines, with many jurisdictions then having some claim to being the insolvency jurisdiction. Moreover, key decision-making and financial and risk control activities are likely to be centralised in one or a few financial centres, the result of both economies of scale and the sound practice of consolidated risk management. Both practices are facilitated by modern communications and air travel.

Thus, even if the firm's business appears separable by jurisdictions,[22] as a practical matter, the business within a single jurisdiction could not be reorganised on a standalone basis. (This does not preclude sales of business lines, but limits sales of business offices.) The firm's executives across locations must cooperate for business strategy, management and risk control reasons. The accounting consolidation of subsidiaries further reduces any jurisdictional compartmentalisation of an organisation by subsidiaries. In any case, some organisations - notably banks - are unwilling to employ the subsidiary device for their principal operations, which tends to raise the cost of operations and degrade organisational creditworthiness. As a result of all these factors, the business activities of financial firms frequently overlap jurisdictional lines.

While global non-financial firms may have more physical assets that can be easily attributed to individual jurisdictions, their business line and management structure may have characteristics similar to those of global financial firms. Moreover, their financial management may have many similarities to global financial firm management. For example, some global non-financial firms centralise their treasury operations in one or a few centres.

In addition, many financial markets are now global. The same financial products are traded worldwide, among counterparties who may be anywhere, while settlement often remains located in a single centre, depending on the product. This gives rise to complex cross-border relations, which place stress on cross-border insolvency law. Collateral, for example, is often "located" in different jurisdictions than the "location" of the debt it secures. Location is a difficult concept for debt and many of the intangibles that comprise collateral. An intangible is located wherever a

[21] Joint Forum on Financial Conglomerates, *Supervision of financial conglomerates,* BIS (February 1999).

[22] The most favourable case may be fairly typical: the subsidiary device used as a form of jurisdictional compartmentalisation, with relatively simple arm's-length cross-affiliate financial structures.

court says it is, raising potential problems of multiple liability and unpredictable perfection of security interests. Many international treaties have sought - often successfully - to mitigate this potential confusion. Some of them are discussed below.

3. The need for speed

Today's rapid marketplace conflicts with the slow, deliberate process inherent in most traditional insolvency processes. Insolvency has two sources of delay: it is often initiated late, when the value of the firm has greatly eroded, and it usually proceeds slowly once it is initiated. Late initiation was discussed above, in connection with insolvency governance.[23] This subsection focuses on the speed of insolvency, once initiated.

Reorganisations are inherently slow, because complex negotiation is part of the process. Liquidations can be fast in principle (especially if the firm is sold as a unit), but are often very slow in practice. Even if the assets are quickly sold, contingent liabilities can slow the distribution of assets, especially for firms with a large number of such liabilities on their balance sheets, such as insurers. The traditional processes, therefore, seem to have a basic time unit of months: months to initiate, months to organise the parties, and months for subsequent steps. Some processes may take only a month or even less, eg organising committees or an accelerated liquidation. Others may take tens of months: negotiations. And the insolvency may be initiated years later than it should.

The slowness of these processes contrasts with a financial market environment that can change in hours, a market for corporate information that acts in days or weeks, a product market environment that be transformed in a few months, and labour markets that often provide rapid opportunities for employment elsewhere. This gap generates another set of tensions in the insolvency process.

First, the increased volume and timeliness of information raises the potential for "fire sale" or adverse pricing, even at an early stage of restructuring or liquidation. When information was poorer and disseminated more slowly, troubled firms had time to work off large positions. In recent years, troubled firms, especially large firms or firms with large positions in financial or non-financial markets, have found that news of their problems travels fast. Markets rapidly incorporate information about possible asset sales or insolvency into prices, and thus the firm faces much more unfavourable conditions for restructuring or liquidation when that finally occurs. This development argues that to maximise the value to shareholders of a troubled firm, serious consideration of any restructuring needs to take place early, perhaps before the odds of insolvency become overwhelming.

Second, over the last 20 years, a far more active financial management approach has become necessary. This has been very noticeable in financial firms, which employ daily mark to market

[23] See Section II-B-2.

accounting and active risk management for their financial contracting. This practice is in tension with slow insolvency law. Daily market, credit and liquidity risk management loses much of its utility if the surviving firm cannot quickly liquidate, adjust or fund its positions. In addition, skilled personnel need to be retained to manage such portfolios.

The need for active management in financial businesses applies more broadly to all businesses, because of more intense competition and rapid technological innovation. Firms in protracted reorganisation tend to lose value, and this tendency is more pronounced in a dynamic economy. A reorganising firm is probably less able to keep up with the changing markets and shortened investment cycles in which it must compete. Furthermore, human capital is seldom subject to reorganisation moratoriums,[24] and represents an increasing share of firm value. Much of this human capital is not so firm-specific that it cannot leave during the period of prolonged uncertainty of a reorganisation. This is especially true in advanced economy workforces that are increasingly professionalised and decreasingly bound to their employing organisations. In many industries, one can question whether the going-concern value preserved by the moratorium is exceeded by the value destroyed in a prolonged reorganisation process. Furthermore, intangible assets such as franchise value (not on the balance sheet) tend to decay in value over time if customers are not carefully monitored and the future of the franchise is not clear. This trend is especially pronounced in a service economy, in which customers expect an ongoing relationship with their suppliers, and thus are more sensitive to their suppliers' insolvency risk.

4. The overlap of banking, other financial, and non-financial firms

The convergence of the timing needs of banks and other firms is just part of an increasing overlap among different types of firms. Banks have traditionally been viewed as special, subject to special regulatory and (in some jurisdictions) insolvency law procedures. This may be changing to some extent. Non-bank firms are taking on more bank-like characteristics, such as liquidity- and market-sensitive trading activities, credit extension, and active risk management.

One principal reason is the well-known blurring of traditional business lines among financial firms with different licences or charters. Another reason is the growth of sophisticated financial activities at large non-financial firms, either in the management of their capital, funding and risks, or in providing financial services for customers, or both. The financial activities of some large non-financial firms are comparable to those of financial institutions.

More fundamentally, features of financial markets are increasingly being incorporated into non-financial markets, especially with the growth of the internet and widespread availability of sophisticated data processing. These include more price transparency, the greater speed of

[24] There are some isolated exceptions, related to intellectual property and competition issues (eg trade secrets and covenants not to compete), and trade unions (which in some jurisdictions, can be ordered by courts not to strike). However, as a good first approximation, these exceptions are just that - exceptional. Most economies permit their workers to leave their jobs at will, regardless of their employers' financial condition.

transactions, easier price and product comparison, better secondary markets for existing goods and, especially, changes in the mechanisms for payment.

This increasing overlap is important to the extent that a jurisdiction has a special bank insolvency regime. Most of the distinctive aspects of specialised bank insolvency law are designed with banks' unique roles in mind. These unique roles are increasingly imitated in the non-financial sector, especially in the emerging B2B (business-to-business) marketplaces, which are often modelled on exchanges or auction mechanisms. Thus, the expedited procedures being developed for banks may be relevant. Banks accommodate liquidity, operate or participate in central clearing and settlement mechanisms, rapidly intermediate transactions between remote parties, and lack powerful creditors. Liquidity is impaired - perhaps systemically - if the failure of a major counterparty ties up the transaction flow. Bank insolvency and payment law therefore seeks to retain systemic liquidity, through precise finality rules, a preference for very rapid reorganisation over liquidation, fast liquidation procedures, and the like. Intermediation connotes the involvement of many entities in a single transaction - which demands sharply defined rights of all the entities, structured as clean bilateral relations. (In other words, adverse claims on funds are very difficult to establish.) Central clearing and settlement connotes an extensive reliance on collateralisation and netting, and thus the rapid enforceability of security interests and netting arrangements, even in insolvency.

D. Financial contracts at the national level

The differential rates of change between financial markets and insolvency practice have also created concerns about settlement risk of payments and financial instruments used for liquidity and risk management, for financial and non-financial counterparties alike. (Settlement risk extends to payment systems, securities transfers and financial contracts - including derivatives, securitisations and other contracts which may be collateralised.) Settlement risk in insolvency is incompatible with the operation of the payment and securities transfer systems, and the uses of financial instruments to manage risk.

Over the past 15 years or so, these risks have been mitigated through special legal exceptions to general principles of insolvency law, often called "carve-outs."[25] These laws include those enforcing closeout netting of derivative and foreign exchange contracts, multilateral netting of payment systems, collateral arrangements securing these contracts, and netting and collateralisation of financial securities contracts: securities settlement, repos and securities lending. For example, collateral used for financial contracts or the financial contracts themselves are insulated from the effects of insolvency arrangements (whether liquidation or reorganisation measures) either through laws permitting rapid liquidation, closeout and netting of obligations

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[25] Some jurisdictions have promulgated fewer carve-outs than others, because their law was already relatively friendly to closeout netting and rapid liquidation of collateral. However, even most of these jurisdictions need special legal protection for financial specialties, such as clearing and settlement operations.

and collateral or title transfer mechanisms. Or, to take another example, securities transfers may be exempted from ordinary insolvency rules concerning preferential transfer, reducing the risk of reversing the transfer in insolvency. These special rules resolve either partly or fully large gross claims and gross liabilities between counterparties immediately upon insolvency, in effect placing or settling these claims ahead of other secured and unsecured creditors and other stakeholders.

These rules have certainly been successful in their own terms. They have undoubtedly reduced settlement risk in particular, and systemic risk in general. By way of comparison, the 1974 Herstatt insolvency created worldwide distress, whereas the 1995 Barings insolvency barely caused a ripple.[26] These insolvencies were certainly different in many respects, but decreased legal settlement risk was certainly a significant one. However, the scope of the carve-out rules is elastic. There is no widespread consensus on which contracts should be subject to these carve-outs. As markets rapidly evolve, the scope of these provisions is effectively widening. No static list of carve-outs can accommodate market evolution, and there are no common principles to fill the gap. Therefore, although most jurisdictions have carve-outs, each jurisdiction has a different list of carve-outs, and updates its current list at different rates than other jurisdictions. This creates frictions among jurisdictions, discussed in the section on cross-border insolvency.

It is difficult to evaluate the countervailing forces involved in the rules governing financial contracts. The argument for an insolvency regime supportive of legally certain netting and rapid enforcement of collateral is strong. If such regimes did not exist, creditors would avoid heavily netted contracts or contracts such as repos whose small margins are only justifiable if collateral enforcement is swift and certain. The result: a thinner market that cannot take advantage of modern risk transfer technology. The argument is even stronger for payment system netting, which could not support large payment volumes on little capital without strong netting and collateral enforcement rules.

However, if resolution regimes are too supportive of netting and collateralisation, the unsecured creditors of the firm will insist on compensation, in the form of higher interest rates, greater overdraft privileges or the like. Unsecured creditors who enjoy deposit insurance might not mitigate their risks, but instead pass it on to the insurer, who would therefore ultimately underwrite the cost of netting and collateralisation. Excessive netting and collateralisation might also render the insolvency process largely irrelevant. In the event of actual or impending default, creditors may merely seek to enforce their security or exercise rights of closeout. In such a regime, if firm-specific transactions are secured or netted, the institution will cease to exist, to the detriment of unsecured creditors, and with the loss of any firm-specific value, assuming some value exists.

[26] The Barings insolvency was smooth for at least two reasons. First, most of the Barings derivatives liabilities were subject to adequate risk management, both that of Barings' counterparties and that of the Singapore exchange, which served as a central counterparty for many of Barings' exchange-traded liabilities. Second, Barings' bank was quickly sold as a unit, although the holding company was subjected to a prolonged liquidation.

E. Impact on legal certainty, efficiency and equity

The changes described above appear to have changed the relative importance among the three goals of legal certainty, efficiency and equity.

The gap between the market environment and insolvency processes suggests that the demand for legal certainty and for efficiency in the insolvency process by creditors and debtors has increased as market participants manage their risks more closely, as competition and globalisation have increased, and as assets have taken on a more intangible character that argues for quicker disposal. At the same time, the increasing liquidity of financial and non-financial assets, the growth of markets for corporate control, and the ability to fashion contracts to solve incentive problems in reorganisation or liquidation have increased the possibility of reducing the costs of legal uncertainty and inefficiency without changing the underlying concepts of equity. Slow and indeterminate negotiations can now be replaced with faster and surer market-oriented practices. In effect, the demand for more certain and efficient insolvency resolution has risen, while the supply (ie legal and transactional technology) for more certain and efficient insolvency has also expanded.

If uncertainty and inefficiency can be reduced, the overall value of the insolvent estate can increase. At a minimum in such circumstances, at least some creditors and other stakeholders can be made better off without making any other stakeholder worse off, and, if desired, basic equity relationships could be maintained.

The development of financial contracts represents a partial closing of the gap between the market environment and insolvency processes, for those instruments where the tensions are most acute. The special exceptions to insolvency law increase legal certainty and efficiency, but at the expense of reordering priorities within the insolvency regime.

The continued development and refinement of approaches to contract enforceability for financial contracts suggests that national jurisdictions have found the approaches, on balance, beneficial. A reasonable inference is that the private benefits in terms of legal certainty and efficiency and the market-wide benefits of limiting market disruption and sustaining liquidity outweigh any loss to other creditors or that the losses of other creditors are small. This inference is plausible: financial contracts do not involve those firm-specific assets whose value would be lost in case of contract enforcement.

In particular, the gains in legal certainty for financial institutions have broad spillover effects or external economies. Financial institutions are particularly susceptible to a loss of confidence. Anticipation of the closure of a financial institution can generate a run on the institution concerned and become a self-fulfilling prophecy. Regimes which seek to improve the chances of the institution remaining a going concern can reduce the risk of systemic shocks being transmitted through the financial sector. But such approaches are likely to be effective only if there is a reasonable degree of certainty that they would be adopted in a particular case. There may be uncertainty about such adoption even in a single jurisdiction, and the interaction of different jurisdictions can make less clear what approach is likely to be taken in a particular case.

However, a gap remains between market possibilities and insolvency practice for other assets and liabilities of the insolvent firm. This gap suggests that additional opportunities exist to increase the legal certainty and efficiency of insolvency processes. This may involve greater use of market mechanisms such as auctions of business units in insolvency proceedings. Both the FDIC in the early 1990s and the bankruptcy trustee in the current Enron case used such methods. These present the possibility of essentially equity-neutral gains in efficiency and legal uncertainty.

More refined questions about the efficiency consequences of insolvency regimes lie somewhat outside the scope of this paper, but deserve at least some discussion. Insolvency regimes have incentive effects on the behaviour of firms and their counterparties. Some incentives enhance efficiency; others do not. This has been discussed above, in connection with the initiation of insolvency and subsequent insolvency processes[27] but also applies to other insolvency rules. For example, priority rules that shift insolvency risk from unsophisticated parties (eg employees or depositors) to financial creditors may enhance the efficacy of monitoring by the more sophisticated creditors.[28] (Such rules would also increase the cost of credit.) Or, to pick another example, legally certain and rapidly enforceable security interests decrease a secured creditor's interest in reorganising a firm.

III. Coordination of national insolvency processes: cross-border aspects of insolvency

Cross-border insolvency has received a tremendous amount of attention during the last decade, with genuine progress towards international law reform. This progress has been on two fronts: coordination of national insolvency proceedings and the problems unique to the insolvency of international financial firms: liquidity management, settlement risk and ensuing systemic risk.

This section begins with an analysis of the problems of coordinating cross-border insolvency. Problems in coordination apply both to insolvency processes and to substantive insolvency rules, notably the carve-outs discussed above. It then applies this analysis to the schemes actually used to coordinate cross-border insolvency, so-called "full universality," "modified universality," and "territoriality." It describes how cross-border coordination issues are somewhat different for banks than for general business firms. The section concludes with a brief review of current law reform movements. Appendix A chronicles this progress in detail, especially with regard to bank insolvency.

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[27] See Section II-B-2 above.

[28] This argument is a hardy perennial in discussions of deposit insurance. See for example Helen Garten, "Banking on the market: relying on depositors to control bank risks", *4 Yale Journal of Regulation 129* (1986).

The conclusions of this section are complex, and deserve a brief summary here. First, it is difficult to coordinate international insolvencies, and the appropriate coordination schemes for banks might not be those of general business firms. Second, the predominant (if not necessarily optimal) coordination model today is based on **comity**: voluntary cooperation among insolvency courts and Officials. Outside the European Union, there is little in the way of treaties that coordinate cross-border insolvency.[29] Third, although the coordination of cross-border insolvency *procedures* may be weak, there has been considerable progress in harmonising cross-border insolvency *rules*, notably those related to the conflict of laws, financial contract netting and rapid liquidation of financial collateral.

A. The problems of insolvency coordination in an international context

Legal certainty is as valuable in a cross-border world as it is within a single jurisdiction. However, legal certainty is more difficult to attain across borders. Which law will govern the insolvency proceeding or will multiple laws apply? Which law will determine whether a security interest is perfected or a netting contract is valid? These questions are particularly important for financial institutions. Within a particular jurisdiction, most financial contracts enjoy considerable legal certainty. Will this certainty be retained in an international context, especially in insolvency?

Uncertainty over financial contracting has two salient dimensions in an international context. One of them concerns the choice of an insolvency regime and the potential for forum shopping. The other concerns the frictions between different regimes, even after the relevant forum (or forums) have been selected.

1. Choice of an insolvency jurisdiction

Different jurisdictions have different distributional consequences in insolvency. Therefore, those who have the ability to invoke an insolvency regime have an incentive to invoke the jurisdiction most favourable to them: the "forum shopping" problem. If only one party were free to select a jurisdiction, forum shopping would not necessarily create uncertainty: it would merely mean that insolvency regime would be the most favourable one, from the party's perspective. Since the relevant party is usually the debtor, we would expect to see pro-debtor regimes flourish, to the extent the debtor has a choice of jurisdiction.

However, the ability to initiate insolvency could rest with different parties, such as creditors, directors or shareholders in the institution concerned, or a relevant supervisory or regulatory authority or other administrative body. This creates genuine legal uncertainty, as well as the distortion mentioned above. Who will be the first to file? Another layer of uncertainty may exist where a court or other judicial body has discretion to decide whether the application proceeds or

[29] The Bustamente treaty, in force in much of South America, is perhaps the best-known example.

is successful, or perhaps to discontinue one type of procedure and substitute another on the application of other interested parties.[30] Finally, there is the prospect of two competing regimes, initiated by two parties with separate interests in the insolvency. As a result it may be difficult to predict whether and which regime will be triggered in any particular circumstances.

One can view forum shopping from two perspectives: ex ante and ex post.

Ex ante forum shopping is simple in concept. Business tends to seek the lowest-cost environment, for labour, capital and other inputs. This applies as much to the legal environment, as any other. If a firm could credibly associate itself with a jurisdiction having capital-friendly insolvency law, its cost of capital would decrease. This could, in principle, initiate a wholesome competition among legal systems for more capital-friendly insolvency law. In other words, there is not always a race to the bottom. However, this kind of forum shopping would undercut insolvency policies that give greater weight to labour and communities.

Although the prospect of ex ante insolvency forum shopping is intriguing, it is also at present not a major factor in choosing business location.[31] It is commonly believed that business, tax and corporate control reasons dominate the choice of principal jurisdiction, for firms that have such a choice. Most legal systems do not allow a free choice of principal jurisdiction. Differences in tax regimes in fact are known to drive choice of corporate domicile.[32] Under some circumstances, discussed below, differences in insolvency regimes might have a similar effect.

Ex post forum shopping, where it is possible, is more likely and more problematic. When a firm becomes distressed, management is likely to seek a jurisdiction that provides the best prospects for itself: a chance to participate in reorganisation and a minimum possibility of penalty for errors in management judgment or misconduct. Although ex ante forum shopping may be desirable, it is more difficult to justify *ex post* forum shopping.

Ex post forum shopping is not a major problem in current international insolvency law, because most legal systems discourage the practice. However, it is not at all hypothetical. It is a well-

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30 Official discretion is a general problem, not limited to the cross-border context. It is common in ordinary insolvency law. For example, a liquidator might be able to decide which contracts to perform (in which case a counterparty will - in the absence of an enforceable contractual provision dealing with termination - still be under an obligation to perform the contract) or to repudiate (in which case the counterparty will only have a right in damages). Alternatively, a counterparty may find that its ability to realise security is exercisable only with the consent of the insolvency Official and/or the consent of the courts.

31 A firm can engage in credible ex ante forum shopping only if the rules are clear and the choice is irrevocable (or at least difficult to reverse). Forum shopping can lead to a competition among legal systems only if there are few constraining relationships between the jurisdiction selection rule and the business activities, assets and locations of the firm. As a general matter, clear jurisdiction selection rules (eg situs of incorporation) are usually revocable, and often constrained.

32 For example, many firms headquartered and operating in the United States have obtained Bermuda charters for tax reasons alone, eg Global Crossing, Tyco and Ingersoll-Rand.

known phenomenon in US general insolvency law,[33] and explains the popularity of pro-creditor bankruptcy courts in Delaware and New York. It is a potential problem whenever a firm can freely change its place of incorporation, incorporation is a sufficient contact for insolvency jurisdiction, and other jurisdictions are obligated to respect this contact. These conditions may be uncommon now, but may become more prevalent with increasing globalisation. We shall discuss the further problems of ex post forum shopping below.

2. Other cross-border dimensions of insolvency procedure

The choice of an insolvency jurisdiction is not the only important cross-border issue regarding insolvency processes. One closely related issue is the choice of jurisdiction for a firm's assets and liabilities, which can often have significant consequences in insolvency. (For example, the law governing setoffs and preferential transfers might be the law of the asset or liability, rather than the law of the insolvency forum.) The location of most liabilities is a matter of contract, especially for global firms. Many financial assets are some other firm's liabilities, and therefore also have a manipulable situs.

As another example, 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 insolvency. However, most jurisdictions do not consolidate in this fashion, and view the appropriate law separately for each entity within the group. The consolidation of subsidiaries is a particularly significant issue for financial firms, and is discussed in more detail below.

One fundamental question at the outset of major insolvency cases is whether a rescue attempt should be undertaken through reorganisation. 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. In a cross-border insolvency case, these can create some obvious problems of inconsistencies. Proceedings taking place concurrently in different jurisdictions with different insolvency laws, where one party's proceedings are not recognised by the other, could lead to contrary conclusions on whether reorganisation or liquidation should be conducted.

3. Enforceability of contracts: netting and realisation of collateral

As discussed above, the enforcement of financial contracts in insolvency proceedings tends to be regulated by "carve-out" statutes. As a general matter, these statutes assure the enforceability of certain kinds of netting agreements notwithstanding insolvency, and assure that certain collateral arrangements can be enforced without hindrance from the insolvency. Unsurprisingly, no two jurisdictions' carve-outs are identical. This can complicate cross-border insolvencies

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[33] The United States permits a bankruptcy filing to be made in any state in which the insolvent party has an insolvent affiliate (28 U.S.C. § 1408(2)). For larger firms, this permits the possibility of substantial forum shopping.

tremendously. Some examples of different jurisdictional approaches to carve-outs are drawn from the Contact Group’s questionnaire:

- The different treatment of “absolute transfer of title mechanism” under different laws, for instance under English law and under Italian law. While the majority of market participants using the ISDA credit support documentation have preferred title transfer arrangements subject to English law, under Italian law such arrangements are deemed vulnerable to re-characterisation as disguised security (these schemes could be recognised as valid and enforceable only if falling in the category of “repos”).

- The different treatment of top-up collateral. While in some jurisdictions top-up collateral delivered in a specified period prior to the commencement of insolvency may be declared null and void (Japan) or ineffective (Italy), in other jurisdictions there is a special protective regime, in the sense that top-up collateral provided for in the context of an agreement relating to qualified financial contracts is valid and enforceable (United States).

- Differences in the valuation of obligations and currency conversions. While in some jurisdictions (Italy) there are mandatory rules for this valuation (with reference to replacement costs, using market values at the date of the declaration of insolvency), in other jurisdictions (Japan, Netherlands, United Kingdom, United States) as a general rule the non-defaulting party has the freedom to determine the valuation method (although in some jurisdictions, ie United Kingdom, the liquidator may have the ability to challenge such valuation if it is not based on “reasonable grounds”).

In a cross-border insolvency, it is not enough to know if a particular carve-out rule is enforceable in one particular jurisdiction. What if the rule is enforceable according to the carve-out rules of the jurisdiction whose law governs the netting or collateral agreement, but not in the jurisdiction (however defined) of the insolvent party? (What are the choice-of-law rules for determining which law governs the agreement?) What if the insolvency proceedings are split among several jurisdictions, a distinct possibility discussed below? These questions may be arcane, but they are very significant. As discussed above, the carve-out rules are widely believed to reduce systemic risk. If they do not work in a cross-border context, they may be less effective than assumed.

4. Perfection of collateral

One important function of the carve-out rules is to permit parties to rapidly realise or enforce financial collateral in insolvency. The enforceability of collateral depends on whether the security interest has been “**perfected**” in the “appropriate” jurisdiction. (Collateral is generally perfected through publicising the security interest in a matter recognised by law, eg registration, notification, control, physical possession, or the like.) The real cross-border problem is that of uniquely determining the appropriate jurisdiction in which the perfection is to occur. The problem is difficult. For the system to work, all jurisdictions must agree on the appropriate conflict-of-law rules to determine the means of perfection, and the conflict-of-law rules should lead to a unique jurisdiction's law. This very difficult problem in international cooperation has been universally solved for only one class of collateral: real estate. Jurisdictions are territorially based, and real estate is both territorial and immobile. All other classes of collateral are more difficult. Financial collateral (eg securities, receivables, derivative contracts, bank deposits, and the like) is intangible, and one might therefore expect that a solution to this problem is impossible. However, financial collateral has been the subject of considerable recent international law harmonisation efforts. These efforts promise to bear fruit over the next decade, and allow most jurisdictions to harmonise their rules on perfection of financial collateral.

The recent European Directive of the European Parliament and of the Council on financial collateral arrangements[34] ("EU Collateral Directive") is intended to determine the appropriate jurisdiction of perfection for cross-border use of financial collateral between EU member states. The Directive defines financial collateral to include transferable securities and cash deposits. (It also includes rules encouraging the rapid realisation of collateral and discouraging clumsy formalities in establishing a security interest.)

UNCITRAL has developed a Convention on the Assignment of Receivables in International Trade - which includes assignments used in factoring, forfaiting, securitisation, project financing and refinancing. The primary purpose of this Convention is to determine the appropriate jurisdiction for perfection of receivables. Although not yet in force, this Convention has been successful enough for UNCITRAL to be tasked with a broader study of secured credit law, with the purpose of identifying possible solutions, ranging from a "model law" to a "convention".

The Hague Conference on Private International Law is working on a draft Convention on the law applicable to dispositions of securities held through intermediaries, with the aim of implementing the "**PRIMA** approach". According to the PRIMA principle, the rights of a holder of such securities provided as collateral will be governed by the law of the country of the relevant intermediary which maintains the securities account.

The scope of the project of the Hague Conference is not to harmonise the substantive laws relating to securities (this project is being considered by UNIDROIT). It is limited to determining the relevant law governing perfection (and most other property rights) for securities held through intermediaries. The Hague Conference project has been anticipated by other legal systems (eg the US UCC Article 8 and the EU Settlement Finality Directive), but the Hague Conference project has the prospect of worldwide reach.

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[34] Directive 2002/47/EC of 6 June 2002, OJ L 168/43.

5. Implications for legal certainty, efficiency and equity

The problems described in this section suggest that in an international context, legal uncertainty can increase dramatically. The choice of insolvency regime can become uncertain, and sometimes even manipulable. Conflicting laws and an absence of mutual recognition can make the enforceability of contracts uncertain. The appropriate jurisdiction for perfecting a security interest in collateral can become nearly impossible to determine.

This uncertainty contributes to inefficiency. Uncertainty creates incentives for debtors and creditors to behave in a manner that protects their respective interest, but may undermine the ability of the insolvency process to maximise the value of the insolvency estate and may create spillover effects on third parties. In addition, the complexity of administration of multi-jurisdiction insolvencies, including the costs of negotiation and litigation, can generate substantial direct costs and delays. Finally, the ex ante costs of planning transactions to accommodate insolvency also increase: legal opinion letters become more profuse and less reliable.

As was discussed in the previous section, legal uncertainty and inefficiency can be reduced. But unlike the closed system of a national insolvency regime, these improvements cannot necessarily be made assuming that the distribution of the proceeds of the insolvency estate can be held constant. Since concepts of equity differ across national borders, a result of the democratic process in each country or region, the choice of regime(s) will affect the distribution of outcomes. To some extent, providing a clear understanding on how insolvencies across jurisdictions will be handled can mitigate the problem, in that market participants can gauge the probabilities of possible outcomes and incorporate them into their ex ante decision-making. It is also possible that more analysis can identify improvements in the coordination mechanism that are relatively equity-neutral.

Efficiency has another dimension - spillover effects to otherwise uninvolved third parties, especially in the form of systemic risk. There is no real disagreement with the objective of avoiding systemic risk and financial instability, particularly in view of the magnitude of the problems that could 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.[35]

[35] *Final Report of the Follow-up Group on incentives to foster implementation of standards*, 11 September 2001, at p 8 on www.fsforum.org. Other publications include *UNCITRAL draft legislative guide on insolvency law*, 2001; Group of Thirty, *Reducing the risks of international insolvency*, Washington DC, 2000; *Orderly and effective insolvency procedures, key issues*, IMF 1999; *Principles and guidelines for effective insolvency and creditor rights systems*, World Bank, April 2001.

B. Approaches to the coordination of insolvency proceedings

The coordination of insolvency proceedings is the most difficult dimension of general cross-border insolvency law. It has implications for the problems discussed above: financial contracting, forum shopping, and the like. Coordination is difficult for several reasons. Substantive insolvency law varies considerably across jurisdictions, and international coordination of insolvency law may endanger valued local considerations of public policy. In contrast, the consensus on cross-border netting and collateralisation is much stronger, and coordination of choice-of-law rules concerning netting and collateral places far less strain on national autonomy.

Coordination may be viewed as a kind of continuum: from a completely centralised global proceeding at one extreme, to a set of completely independent proceedings along territorial lines, at the other. We here seek to assess the cross-border issue for banks, in the context of general cross-border insolvency law.

In both general and bank-specific insolvency law, three cross-border models are conceivable. The first two models go by several names: we shall call them the full and modified **universal model** of insolvency. Both full universal and modified universal insolvency assume a cross-border division of labour, with most "ancillary" jurisdictions acting in aid of a central insolvency process. In a full universal insolvency model, the "main" jurisdiction's insolvency law will govern the insolvency of the entire firm. Typical ancillary roles include collection of assets and imposition of a moratorium, both aiding the central insolvency proceeding, which either reorganises the liabilities or liquidates and distributes assets. These ancillary roles invoke the power of the local court, and some of the law of the ancillary jurisdiction. However, all of the specialised insolvency law - processes, preferences, priorities and the like - is that of the main jurisdiction.[36] As an example of this division of labour, an ancillary court may feel obliged to turn over all local property to the main jurisdiction, but may use its own law to define whether a property right exists.

Full universal insolvency implies a surrender of sovereignty: predefined rules which dictate the respective roles of jurisdictions. Modified universal insolvency retains insolvency sovereignty, but encourages a cooperative approach. Each jurisdiction decides whether it should take a central or ancillary role. Ancillary jurisdictions must decide which non-ancillary foreign jurisdiction should be treated as the "primary" jurisdiction, and which other non-ancillary foreign jurisdictions have the "secondary" role. In the modified universal insolvency model, jurisdictions are supposed to show some deference to the choices of other jurisdictions and to the needs of the system: the so-called "comity of law."

[36] Cf Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L. 160, 30.6.2000, pp 1-18, Article 4(2). The Insolvency Regulation's list includes: the assets associated with the insolvent, debtor and liquidator powers in the proceeding, setoff, permissible claims, creditors' remedies and priorities.

These two models are sharply distinguished from the "**territorial**" insolvency model, which expects no international cooperation. In the territorial insolvency model, each jurisdiction acts independently of the others. The insolvent firm is simply liquidated or reorganised along jurisdictional lines.

Full universality - which requires an international treaty - is often considered attractive.[37] However, the surrender of sovereignty implicit in full universality is difficult to achieve, and modified universality is often viewed as a more attainable norm. The territorial insolvency model is commonly viewed as an outmoded system modelled after pre-war notions of sovereignty and globalisation.[38] However, as we shall see, it has its merits.

The following discussion describes the three models in operation. However, its principal goal is to show that the issues are different for banks. Some problems of each of these models are muted for banks; and some of the problems are accentuated.

1. Full universality

The notion of a coordinated worldwide insolvency proceeding is quite attractive, especially for multinational firms. Proponents of universal insolvency admit that full universality requires a very high degree of international legal cooperation, but otherwise believe that universal proceedings are a desirable goal, worth the transition costs.

A successful implementation of full universality is the new legal regime on financial insolvency adopted by the European Union, applicable to all of its member states, except for Denmark. However, the EU rules clearly represent a special case, not comparable with other attempts at international rule-making, given that this new European cross-border insolvency regime was adopted within the existing EU legal and institutional framework. Even with the advantages of the EU framework and the strong political commitment to general European integration, this initiative was under consideration for over a decade before its adoption. Outside the European Union, fully universalistic international insolvency treaties have been very rare.[39] It is extraordinarily difficult for one country to legislatively surrender its sovereignty to another, even in matters of private law. (Courts have a somewhat easier time surrendering sovereignty on a case-by-case basis: the so-called "comity of law," discussed below.)

In the end, these efforts led to the adoption of three legal acts with respect to the insolvency of different categories of legal entities. Non-financial firms are covered by the one of these acts: the

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37 Professor LoPucki is a rare dissenting voice. See Lynn M. LoPucki, "The case for cooperative territoriality in international insolvency", *98 Michigan Law Review 2216* (2000).

38 The universality and territoriality principles are distinct from the dichotomy between the single entity and separate entity doctrines of bank insolvency law. The single entity doctrine is universalistic. However, the separate entity doctrine is somewhat different than classic territoriality, in that the local insolvency may assert jurisdiction over some assets, generally those booked to the local branch.

39 See footnote 29 above and Appendix A, Part 2.3.1.

so-called "Insolvency Regulation." Financial firms are subject to the other two acts, which take the form of EU directives, one for insurance companies and the other for credit institutions.[40] These legislative acts will coordinate national insolvency proceedings, but do not otherwise harmonise them.

The insurance and credit institution directives prescribe a form of full universality. The administrative or judicial authorities of the "home member state" (the member state where a firm has its head office) are the only ones empowered to implement reorganisation measures or winding-up proceedings concerning a firm, including branches established in other member states. No secondary proceedings may be started by the other member states. In contrast, the more general Insolvency Regulation permits a secondary proceeding under certain circumstances. The Insolvency Regulation therefore may be considered a form of modified universality, albeit one of the more closely coordinated forms.

Although the major objection to full universality is usually impracticability, the argument for universality has its weaknesses, even if the necessary international cooperation can be obtained. Some of these weaknesses are heightened in bank insolvency; others are attenuated.

Forum shopping is a potential problem inherent in universal insolvency proceedings. As discussed above, the problem is largely hypothetical at present (outside the United States), but might become prominent with increased globalisation and a decreased ability to associate a firm with a unique jurisdiction. In a globalised world, it is difficult to design rules that locate firms in a clean and natural fashion. The principal jurisdiction of many major international firms is at least mutable: consider Royal Dutch Shell, DaimlerChrysler, HSBC, AIG or Vivendi.

Implications for banks. Because of accepted international supervisory norms, banks are even less susceptible to ex post forum shopping than most non-financial firms. The comprehensive consolidated supervisor of a bank (or a banking group) is generally quite clear and subject to licensing, and cannot be changed by a quick filing procedure.

Priority inflation is another possible problem associated with universal insolvency models. It occurs when local lawmakers seek to safeguard the interests of their local constituencies. This is possible in a universal regime because the bankruptcy estate is global, but the priority scheme can

[40] Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings (the EU Insolvency Regulation), OJ L 160, 30.6.2000, pp 1-18 (the EU Insolvency Regulation is effective and directly applicable in all EU member states (except for Denmark) as of 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, pp 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, pp 15-23 (the time frame for member states to implement the Winding-up Directive for credit institutions is by 5 May 2004).

disproportionately benefit local creditors, eg tax authorities and employees. The losers are unsecured non-priority creditors, who may be less local than the priority creditors.

There is less risk of priority inflation in the territorial insolvency model, because the total asset and liability pools are smaller than in the universal model, but the local creditor pool is likely to be about the same size. In other words, a territorial model cannot as easily externalise the benefits of local priority creditors onto foreign non-priority creditors. Instead, the costs of a priority regime must be borne more heavily by local non-priority creditors. (As discussed below, the modified universality model is also resistant to exorbitant priority inflation.)

Implications for banks. The problems of priority inflation seem no different for banks or non-financial institutions.

Corporate groups remain a complex problem, even in fully universal proceedings, including the EU insolvency directives. The usual rule in general business insolvency is that each corporation is liquidated separately, often subject to a separate insolvency law. Most attempts at international insolvency cooperation attempt to coordinate these separate liquidations, not merge them. The legal constructs of corporate separateness and affiliate independence are strong.

This anti-consolidation rule causes several classes of problem. First, business operations are frequently entangled among the individual corporate components of groups. This may not matter for merger or whole-firm liquidation, but can be very problematic with most other insolvency proceedings. Piecemeal attempts at reorganisation of a corporate group will tend to lose value.

Second, corporate groups generally have inter-affiliate exposures: often a parental guarantee of subsidiary liabilities, but sometimes far more complex exposures. These can be difficult enough in an ordinary proceeding, and different jurisdictions' rules on consolidation or inter-affiliate subordination can have significant effects in other jurisdictions. While regulatory limits to some extent control inter-affiliate exposures, the risk management and funding needs of financial firms tend to make inter-affiliate exposures of increasing importance as a risk management issue.

Finally, the boundaries of corporate groups are frequently vague: consider problems posed by joint ventures, minority shareholdings, cross-ownerships, and decentralised organisations.

Implications for banks: consolidated comprehensive supervision. The issues of corporate groups are especially important for large, internationally active financial institutions. These firms often adopt management and business line structures that cut across the legal entities in the corporate group. This organisation, plus efforts to centralise the risk management of key global activities, lead to large and diverse inter-affiliate transactions. The indistinct separation of corporate entities within a group is consistent with the "comprehensive consolidated supervision" ("CCS") concept of unified bank supervision. The CCS concept demands a central supervisor responsible for the entire financial group, no matter where the group entities are incorporated. Local supervision and entity-based supervision are not inconsistent with CCS, but the central supervisor is responsible for the entire organisation. Local supervisors are discouraged from permitting entry of financial firms that do not enjoy CCS.

The CCS concept is extremely powerful, because it is a jurisdictional and organisational focal point that could facilitate universal insolvency proceedings applicable to corporate groups. CCS is not susceptible to forum shopping, because it is indisputable ex ante and (relatively) immutable ex post. It permits an organic connection between supervision and insolvency on an international scale, accommodating the business overlap across entity and jurisdictional lines.

CCS is not (yet) an element of financial insolvency law. Financial groups are subject to the same deconsolidated insolvency procedures as non-financial business groups. Agreement to CCS is not the kind of surrender of sovereignty necessary to support fully universalistic bank insolvency. Furthermore, CCS permits considerable diversity of practice, and accommodates a diversity of objectives between home and host country supervisors, and insolvency law. In particular, in some jurisdictions, including the United States, the host country supervisor has statutory responsibility to protect local depositors in the event of a foreign bank failure. Thus, the law provides scope for an insolvency proceeding in the host country's courts. Furthermore, advanced jurisdictions differ on basic questions, such as whether a special bank insolvency regime is advisable

Nonetheless, matters may change with time. The CCS concept is only about a decade old (although it has antecedents in the bank insolvencies of the mid-1970s and the 1970s principle on consolidation set out by the Basel Committee on Banking Supervision and the Basel Concordat), and has become increasingly accepted. The role of CCS in crisis management is increasingly appreciated, and crisis management is a supervisory kin to insolvency. Full universality might be an ideal in a world of sovereigns. If this ideal ever becomes a reality, CCS might play a major role, especially for financial firms.

It is worth noting that banks generally operate through branches, unlike most other international firms, which operate through local subsidiaries. The problem of corporate groups therefore does not apply to most international banks, viewed as standalone entities. (The separate entity doctrine, however, may require separate proceedings for individual branches.) However, as discussed above, larger banks commonly belong to a group and engage in substantial transactions with their non-bank affiliates, so the problems of corporate groups are applicable to banking organisations, even disregarding the separate entity doctrine.

2. Modified universality

In some cases, a modified universal insolvency is indistinguishable from a fully universal insolvency. Sometimes, one jurisdiction is clearly the appropriate one for the main insolvency proceeding. If the other jurisdictions recognise this, and their courts are sufficiently empowered, they can agree to serve as ancillary jurisdictions to the main proceeding. Thus, decentralised cooperative consent amongst courts in different jurisdictions ("comity") can play the same role as binding international law.

Modified universality is becoming the norm, even though full universality is still the ideal. The norm is embodied in the UNCITRAL Model Law on Cross-Border Insolvency, promulgated in 1997. This model law has already been adopted by a few jurisdictions including Mexico, Eritrea, Montenegro and South Africa, and is being considered in others, such as the United Kingdom and the United States. Because it does not sacrifice the sovereignty of insolvency courts, it is probably far easier to implement than full universality.[41] (To the extent that a court decides on an independent proceeding, the model law may be considered a co-operative form of territoriality.)

But although modified universality is similar to full universality, it contains some different strengths and weaknesses. Modified universality contains some safety valves that weaken the promises - and mitigate the weaknesses - of full universality.

- Priority inflation is less of a problem in the modified universal model. A jurisdiction is not likely to assume the ancillary role if the main jurisdiction's priorities are exorbitant.[42] The UNCITRAL Model Law does not compel a jurisdiction to recognise another.

- Forum shopping is more likely to be a different kind of problem in modified universality. The debtor - and creditors - have the option of shopping for multiple forums. However, it is less likely that the debtor can game the rules to select a totally inappropriate forum, because such a forum is unlikely to be recognised by other jurisdictions as the forum of the main proceeding.

- The same issues of corporate groups apply to modified universality.

- Reorganisation is more difficult in modified universality, because of the prospect of defecting jurisdictions. (This is less relevant to financial institutions, whose supervisor-led or -encouraged reorganisations usually occur without formal insolvency.)

- A comity-based system such as modified territoriality may become less stable as the largest firms regulated by the system grow in size and complexity, especially because a single uncooperative legal system can impose heavy costs on all others, if it contains enough assets. Fortunately, however, the legal systems of most major national economies appreciate the need for international cooperation.

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[41] It should be noted that the EU Insolvency Regulation also allows for secondary proceedings.

[42] See In re Treco, 240 F.3d 148 (2d Cir. 2001). In this case, the US court refused to assume an ancillary role with respect to a security interest, because the overseas proceeding accorded the administrator's expenses priority over security interests. Since the administrator had collected around $10 million, with all but $1.75 million disbursed to it in expenses, it appeared as if the US security interest would be completely worthless, if turned over to the administrator.

In summary, modified universality is no stronger than comity, which has worked well to date. Comity requires that a court favour systemic concerns over local ones. This implies both support of global concerns and some degree of insensitivity to local concerns. If local concerns are deeply felt - and bank regulation often raises strong local emotions - a court may be less likely to grant comity to another court.

3. Territoriality

Territoriality places fewer strains on international cooperation than full or even modified universality. It does not preclude cooperation among jurisdictions, but tends to encourage at best a modest degree of cooperation: information-sharing, ad hoc cooperation, and the like. It does not permit the more pernicious forms of forum shopping, but - as discussed above - may encourage some useful forms of jurisdictional competition for financial assets.

Inefficiency is probably characteristic of territoriality, as compared to universality. The territorial insolvency model involves multiple proceedings and races for assets by both Officials and creditors. (Intangible assets present the spectre of multiple liability, although this may soon be mitigated by the Hague Conference and UNCITRAL projects discussed above.) Some assets may be subject to no insolvency proceeding at all, eg if they are located in a territorial jurisdiction whose requirements for insolvency are not met. Inter-affiliate obligations - difficult enough in the universal model - become even more difficult to sort in the territorial model. Such an inefficient system is probably unfair, because stronger creditors tend to do better in a legal free-for-all.

Reorganisations of unsupervised firms are very difficult in the territorial model, unless the relevant jurisdictions are extremely cooperative. Reorganisations imply that the insolvent will be run as a going concern - something very difficult for a multinational business partitioned by an insolvency proceeding into territorial units. This is mitigated, to some extent, by non-financial firms' common practice of compartmentalising a multinational firm by subsidiaries that mostly follow jurisdictional lines. The reorganisation problem is potentially problematic for regulated financial services, since they are more likely to use branches than affiliated organisations, and are more likely to conduct the same business line using several affiliates. However, in banking and insurance, most reorganisations are conducted or encouraged informally by home-country supervisors, without use of the insolvency apparatus. Such reorganisations are not hindered by the territorial model, but require supervisory cooperation.

Forum shopping, at least in the forms seen in universal models, is not characteristic of territoriality. Territorial insolvencies occur where the assets are, not where the parties choose to file. But another kind of forum shopping is possible in territorial models. Most financial assets - and all liabilities - are intangibles: loans, securities, deposits and derivatives. At least with respect to securities and deposits (and possibly derivatives), a financial firm can often choose the location of its assets with a stroke of the pen, without substantially affecting its underlying business. A financial firm can also choose the location of its liabilities, at least for wholesale placements.

Therefore, a kind of ex ante forum shopping is possible in the territorial model. As discussed above, ex ante forum shopping may be desirable, under some circumstances.

Supervisory cooperation and competition are strongly affected by territoriality. In the territorial model, supervisors will tend to look out for their local balance sheets and thus have ex ante incentives to monitor the financial institution closely. In other words, territoriality reduces the externalities inherent in home-host divisions of supervisory responsibilities. However, vigorous host-country supervision of financial firms may face the same problems as in the universal model: business line organisations that cut across jurisdictional lines, centralised decision-making and control functions, and "global" books that include transactions originated in other jurisdictions. In other words, territoriality may provide good supervisory incentives for the host country, but the incentives are more compatible with the supervision of less complex firms.

The flip side of good supervisory incentives for the host country is a reduced chance of supervisory cooperation on the eve of insolvency, and during the insolvency process. In the territorial model, home and host supervisors will become unwilling to share financial information on weak firms once they suspect insolvency is imminent. This may make reorganisation more difficult, and any insolvency less efficient.

Cross-border carve-out rules can be conceptually difficult to reconcile with a pure territorial model. Why should an Official recognise the netting of a foreign debt against a domestic debt, when the Official is committed to ignoring foreign assets and liabilities? Or why should an Official recognise a domestic asset as securing a foreign debt that is outside the scope of the administration in any case? Few territorial models are pure, and some territorial models explicitly recognise cross-border netting.[43] Of course, there is nothing inherent to a universal or modified universal model that ensures that it will enforce cross-border netting and collateralisation agreements. However, it is safe to say that territorial models are less likely to be receptive to cross-border netting and collateralisation than universalistic models.

Financial and non-financial institutions are both affected by these problems. Banks rely on netting and collateralisation in their risk management, which could frequently be cross-border. Non-financial organisations frequently employ cross-affiliate guarantees, which have a cross-border component.

A coordinated international workout or insolvency of financial institutions is especially important to manage systemic risk. This places some real strain on territoriality. Without an effective coordinated response, a run on the institution is conceivable.[44] Even secured creditors and market

43 NY Banking Laws § 618-a.

44 The presence of deposit insurance will limit such behaviour but it may not prevent runs both because depositors will want to avoid the inconvenience of their funds being temporarily frozen until the insurance is paid and because there may be limits on the extent of cover (eg there may be an upper limit on the amount of insured deposits, or

counterparties may join the run if they doubt their position under at least some jurisdictions.[45] However, territoriality - although it impairs supervisory cooperation - tends to be less complex, and thus less legally uncertain, than modified universality or a poorly coordinated full universality.

C. Current initiatives in cross-border insolvency

This subsection summarises the recent history of cross-border insolvency reform efforts. It does not discuss the substance of these efforts - that is the role of Appendix A. Instead, it enumerates the efforts, places them in a chronology, and discusses the various players behind them.

Only some of these initiatives are statutory, ie model laws or conventions. Statutes are not the only mechanism of legal reform, and are generally promulgated only after a consensus on law reform has been developed by organisations without legislative power. These organisations may include public sector entities without legislative power (eg national central banks or various treaty organisations), or various kinds of private sector organisations. Although private sector organisations inherently have no legislative power, the trade codes and model agreements that they promulgate are often drivers for law reform and themselves quasi-legislative in effect, eg the ISDA model derivatives agreements or the ICC's efforts in letters of credit. (Cases of judicial decision-making can also be a significant driver of law reform, although we do not discuss them here.[46])

1. Legislative initiatives

Most of the international legislative initiatives have already been discussed, and merely need to be summarised here. They can most compactly be presented in tabular form. Particularly noteworthy are the recent dates of all the initiatives. Table 3 clearly shows that cross-border insolvency reform is new. The legislation is the fruit of efforts that began in the early 1990s, often originating from the private or financial policy sectors. These efforts had been preceded, in many jurisdictions, by national law reform efforts with the same scope: a trend to modified universality, and various netting and collateral rules that minimised settlement risk.

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foreign currency or overseas branch deposits may not be covered). Furthermore, depositors may be uncertain whether and how the deposit protection scheme applies.

45 For market counterparties relying on rights of setoff or closeout netting, these may well be protected or enforceable notwithstanding liquidation proceedings or reorganisation measures, but there may in practice be confusion as to whether the relevant contractual right to trigger such setoff or closeout netting has indeed arisen (which may depend on whether any formal steps for the commencement of the resolution mechanism concerned have indeed been started). Such uncertainty will be more likely if the insolvency proceedings are in a "foreign" jurisdiction, and therefore of unfamiliar nature or extent.

46 For example, the cooperation between English and US courts in the insolvency of the Maxwell companies was a significant part of the backdrop for the UNCITRAL Model Law on Cross-Border Insolvency.

Table 3

Leg. body	Name	Date	Subject
UNCITRAL	Model Law on Cross-Border Insolvency	1997	Modified universality
EU	Settlement Directive	1998	Netting payments/securities transfers and financial collateral enforceability
UNCITRAL	Receivables Convention	1999	Conflict of law - collateral perfection
EU	Insolvency Regulation	2000	Modified universality
EU	Winding Up - Banks	2000	Full universality
EU	Winding Up - Insurance	2000	Full universality
Hague Conference	Draft Convention on law applicable to securities held through indirect holding systems	--	Conflict of law - collateral perfection
EU	Collateral Directive	2002	Financial collateral enforceability and conflict of law
UNCITRAL	Draft Legislative Guide on Insolvency Law	--	Best practices - municipal insolvency law

2. *Private sector initiatives*

Private sector trade and professional associations have been very active in the international insolvency law revision process. Some of their products are quasi-legislative, such as the International Bar Association's Cross-Border Insolvency Concordat. These organisations also hold symposia, some of which are published, sometimes with seminal results.[47] Finally, these organisations are very active as NGOs in the international legislative process.

These organisations include (in alphabetical order): EMTA (Trade Association for the Emerging Markets), IBA (International Bar Association), INSOL International (International Federation of Insolvency Professionals), and ISDA (International Swaps and Derivatives Association).

Most of these groups represent the viewpoint of practitioners: chiefly insolvency lawyers, accountants and judges. This has many benefits: practitioners are more knowledgeable about the

47 For example, Randall Guynn's 1996 article for the International Bar Association, *Modernizing securities ownership, transfer and pledging laws,* started the process that led to the Hague Conference project on securities held through intermediaries.

operational details of insolvency than any other group interested in insolvency. Furthermore, the practitioners represent all the players in an insolvency: officials, creditors and others. However, practitioners tend to view the world from an ex post prism, whilst financial institutions and their attorneys plan transactions ex ante.

3. International financial policymakers

As a core business practice, insolvency engages widespread attention. It is important to many beyond the group of lawyers, accountants and other practitioners who draft the rules and administer the processes. Insolvency is particularly important to international financial policymakers. This report, therefore, is part of a tradition of insolvency law reform that dates back at least to the BCCI insolvency of 1991. (The Herstatt insolvency of 1974 was an important antecedent that helped lead to the netting carve-out legislation of the late 1980s.) Subsequent milestones have included:[48]

- The G30's 1998 study group report *International insolvencies in the financial sector.*
- The BIS 1999 symposium on international bank insolvencies.
- The current IMF project on bank insolvency.
- The World Bank's Bank Insolvency Initiative.

These efforts consider insolvency primarily from a legal perspective and have had substantial input from insolvency practitioners.

IV. Conclusions and new directions

The analysis in this report suggests that the legal uncertainty, inefficiency and potential inequity resulting from the existing legal and institutional underpinnings of insolvency may be incompatible with important objectives of public policy related to financial stability. Moreover, the risks involved may be growing as the pace of change in the financial system continues to outstrip that of the insolvency framework.

This section describes some possibilities for what can be done in the medium and longer term. Many of these possible paths are complementary, and can be pursued in parallel. They are listed in very approximate order of priority.

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[48] Most of the information here comes from the G30 study group report *Reducing the risk of international insolvency: a compendium of work in progress* (2000).

A. Financial contracts and collateral in national law

Financial contracts are not usually a major problem in general insolvency cases, but along with collateral loom large in the insolvency of financial institutions. General insolvency law places no particular stress on rapid liquidation of collateral; financial institution insolvency often does. Both general and financial insolvency law requires international consensus on the perfection rules for cross-border collateral.

Many of the problems are cross-border, and will be discussed immediately below. But at least two questions can profitably be viewed as matters of local law. First, when should national law recognise set-off? Second, when should it recognise rapid liquidation of collateral? The report hints at some criteria that are useful for answering both questions.

Some set-offs enable valuable practices or markets; others are merely wealth distributions from general to favoured creditors. The former set-offs should definitely be protected: automatically permitted without being subject to any moratoriums. These set-offs include payment system netting and derivatives closeouts, both of which substantially reduce settlement-related risk. Other set-offs do not enable financial market practices, and have a predominantly distributive effect among general creditors and setoff claimants. These set-offs may be safely left to individual jurisdictions' sense of equity.

Even clearer criteria exist for rapid liquidation of collateral, free from any insolvency moratorium. The conceptual key is firm-specificity of collateral. The economic value of firm-specific collateral would be dissipated if it were liquidated separately from the firm. This insight can justify the inclusion of such collateral (eg complex machinery) in a reorganisation proceeding, denying the secured creditor's enforcement rights. (Firm-specificity appears to be the main argument for reorganisation over liquidation.) Whatever the merits of this argument, it does not apply to non-firm-specific collateral. No value is dissipated if this collateral is liquidated by the secured creditor outside the insolvency proceeding: it is worth as much to the secured party as it is to the insolvent. Such collateral includes securities and receivables. This argument is especially salient for the collateral securing financial contracts, but applies to all non-firm-specific collateral.

There is a residual argument for including non-firm-specific collateral in the insolvency estate. A freeze on creditors' remedies temporarily provides valuable assets for recapitalising the firm. However, this argument is not consistent with the existence and availability of outside capital markets, including debtor-in-possession financing. It is worth noting that asset securitisations - which remove those securitised assets from the insolvency proceeding - almost always involve non-firm-specific assets, such as receivables.

B. Cross-border issues

There are many opportunities for improvement of cross-border insolvency law. There is much to be gained by broader adoption of existing international standards for general insolvency and collateral law: the UNCITRAL Model Law on Cross-Border Insolvency, the UNCITRAL Convention on the Assignment of Receivables in International Trade, and - once promulgated - the Hague Conference's Draft Convention on law applicable to securities held through indirect holding systems. The EU Insolvency Regulation might also be desirable on a wider scale, despite the practical difficulties of implementing such ambitious legislation. The universality and comity approaches implicit in the EU insolvency legislation and the UNCITRAL Model Law are useful and effective developments in dealing with cross-border insolvency.

Several open questions remain. First, should the UNCITRAL Model Law on Cross-Border Insolvency be extended to banks or other financial institutions, which the Model Law leaves as a local option? There may be a conflict between currently different national approaches to bank insolvency law in a cross-border context when some jurisdictions adopt a single entity approach and others a separate entity approach. One example where the outcome was affected by these different approaches was the liquidation of BCCI. In the single entity approach assets are pooled and distributed to creditors according to priorities set for the whole entity (this requires comity of law to establish an accepted basis for determining the relevant jurisdiction - such as place of incorporation). In the separate entity approach certain assets (e.g. in a bank insolvency, those booked to local branches) may be subject to local jurisdiction and used first to meet local claims. Where jurisdictions adopt different approaches the outcome may not seem equitable to all creditors.

Second, will widespread adoption of the Hague Convention be sufficient for securities, or is harmonisation of substantive law also necessary? Securities, of course, are by far the most significant source of financial collateral in the market, and cross-border collateralisation is now common. Well-harmonised conflict of law rules are necessary, but may not be sufficient, for a harmonised cross-border legal regime.[49]

Third, is there a need for an international netting treaty for settlement risk, and - if so - should such a treaty be aimed generally or only at the advanced jurisdictions that pose the greatest settlement risk?

C. Contract- and market-based insolvencies

Since the mid-1970s or early 1980s, a large academic literature on alternatives to insolvency has developed on both sides of the Atlantic, associated with names such as Oliver Hart, Philippe Aghion, Mark Roe and Alan Schwartz.[50] These names include both economists and lawyers

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[49] Luca G Radicati di Brozolo, "Conflicts of laws issues of international payments", in *International Monetary Law (*M Giovanoli, ed, Oxford 2000).

[50] See for example Philippe Aghion, Oliver Hart and John Moore, "The economics of bankruptcy reform", 8 *Journal of Law, Economics & Organisation* 523 (1992); Lucien Arye Bebchuk, "A new approach to corporate reorganisations", 101 *Harvard Law Review* 775 (1988); Michael Bradley and Michael Rosenzweig, "The untenable case for Chapter 11", *101 Yale Law Journal*, 1043 (1992); Alan Schwartz, "Contracting About Bankruptcy", 13

working in the law-and-economics tradition. This literature generally shows a great distrust for insolvency reorganisations, for many of the reasons discussed above in this report: particularly the structure of the governance of reorganisation, including attendant decision processes. The literature distrusts both Official-centred procedures and the negotiation process inherent in most stakeholder-centred procedures.

The policy prescriptions in this literature vary, from insolvency proceedings variable by ex ante contract to various auction or option proceedings.

Auction proceedings assume an outside source of capital: employing either all-cash or more complex bids to establish the value of the firm, and having the bids approved by the creditors through some kind of voting or tender procedure, which accommodates holdout problems. Insolvency auctions are not novel: many restructurings and even bulk liquidations employ auctions. However, in these contexts, auctions are not the centrepiece of the insolvency procedure, as has been recommended by some of the academic literature. Conventional Chapter 11-style reorganisations still assume that outside capital is the exception, rather than the rule.

Option procedures employ internal capital, eg by issuing options with appropriate exercise prices or redemption rights granted depending on the holder's position in the capital structure. Appropriate transferable options will create incentives for the option holders to, in effect, value the firm. Like the auction proceeding, an option procedure uses a market mechanism to replace the negotiation mechanism inherent in modern reorganisations. However, the option procedure does not require an outside capital market.

Insolvency-by-contract is a truly radical idea: that all creditors can contract in advance to a particular insolvency process or rule. This idea is probably infeasible if taken to its limit, because involuntary (ie tort) creditors cannot contract, and many voluntary creditors cannot meaningfully contract (eg trade creditors, employees). However, it might work well to adjust the claims of financial creditors, especially if they are viewed as coming serially to the firm and the monopoly advantages to the first creditor are not excessive. In this respect, it resembles a prepackaged reorganisation negotiated ex ante, before distress. (The usual scope of prepackaged reorganisations is limited to financial creditors; trade creditors are typically paid in full.)

Credit derivatives do not formally affect insolvencies, but may transform the incentives of the players, and thus indirectly insolvency proceedings. Credit derivatives permit a creditor to contract with a third party to hedge its claim on a debtor and to receive a payment immediately upon the occurrence of a default or other "credit event", with such a payment usually based on the actual or proxied market valuation of the claim. The third party usually becomes the creditor, generally without any pre-existing relationship with the debtor. Post-insolvency trading of claims ("vulture capitalism") is similar in this respect. Experience with insolvencies involving credit

Journal of Law, Economics & Organisation, 127 (1997); Mark Roe, *Corporate reorganisation and bankruptcy* (Foundation 2000).

derivatives to date is probably too small (and the recovery process too understudied) to draw immediate conclusions. However, credit derivatives might plausibly reduce the pre-insolvency monitoring incentives of creditors (including their incentives to effect a workout), and create a class of specialised creditors-in-insolvency. The legal underpinnings of the law of credit derivatives are not those of insolvency law, but rather concern their enforceability: both as against the third party and against the insolvent.

D. Prepackaged reorganisations

So-called "prepackaged" reorganisations, although still fairly new, are popular among insolvency practitioners, and appear superior in some respects to conventional reorganisations. A prepackaged reorganisation relies on the same kind of negotiations as a conventional reorganisation, but mostly occurs before the insolvency proceeding is initiated. The initiation of insolvency is a fait accompli, intended only to insure legal protection to out-of-court agreements. A prepackaged insolvency, therefore, disposes with the moratorium, or at least shortens the moratorium period considerably, and probably lowers the costs significantly.

Prepackaged reorganisations are most plausible when a firm has no difficulty meeting its present obligations out of ordinary business revenues (and thus does not need a moratorium), but management nevertheless feels the need to restructure. Recent legal and market evolution has provided such opportunities. For example, some junk bond financings are not payable in the early years (or are "payable in kind"), but impose a severe cash drain in later years. During these early years, management might decide that it will not be able to meet the new cash obligations when they become due. (By no coincidence, prepackaged reorganisations first appeared around 1986, and became very popular by the early 1990s.) Prepackaged reorganisations are also potentially useful in settling pending mass tort cases. Such cases cannot always be settled with a cash payment, because their settlement value exceeds the value of the firm. A prepackaged reorganisation involving the tort creditors becomes a sensible way to settle such a case, resolving tort liability and financial structure simultaneously.

However, if management does not enter the process until the firm has cash flow problems, the prepackaged reorganisation is unlikely to succeed, unless the negotiations can somehow be accelerated. And, as discussed above, management will often have no incentive to do so.

E. Insolvency arbitration

Arbitration is an "alternative dispute resolution" procedure. An arbitrator's powers are akin to those of a judge, for the parties are bound by the arbitration agreement. An arbitrator, however, has no power over those who have not consented to arbitrate.

Insolvency arbitration is often proposed by insolvency practitioners. Proponents of insolvency arbitration believe that specialist insolvency practitioners are better than judges, especially outside advanced industrial countries. They therefore recommend insolvency arbitrations that bind the debtor and its financial creditors (who can all consent), and pay other creditors in full.[51] Proponents of insolvency arbitration also believe that arbitration clauses should be enforced for bilateral insolvency disputes, such as claims resolution and asset collection.

F. Reducing the insolvency estate

As discussed above, modern firms have fewer firm-specific assets than they once had. This is responsible, in part, for a significant trend in insolvency law, which has not received the recognition it has deserved. This approach, in effect, segregates firm-specific assets from non-specific assets, and excludes many of the non-specific assets from the insolvency proceeding.

This new approach has at least three sources: the increasing use of off-balance sheet financing (particularly asset securitisations), the increasing popularity of outsourcing, and the new carve-outs to ordinary insolvency laws that protect financial contracting and liquidation of financial collateral. Outsourcing is usually considered a kind of exogenous factor, unrelated to insolvency. However, a heavily outsourced firm has a smaller balance sheet, and it will therefore have fewer assets tied up in a reorganisation or other insolvency proceeding. The more controversial measures involve off-balance sheet financing and financial collateral liquidation.

Asset securitisation finances various promises to pay, such as mortgages and trade receivables. These assets are not very firm-specific: they are worth almost as much to an assignee as they are to the original creditor. They are therefore easy to finance, using a **special purpose vehicle** structure, which has the legal form of an asset sale free from the insolvency proceeding, but the substance of a secured transaction.

Asset securitisation effectively shrinks the size of the insolvency estate, by carving some non-specific assets from the estate. (Securitisation reduces the estate's obligations pari passu.) Securitisation is attractive. The financier obviously benefits, because it can liquidate its claim outside of the deadweight losses imposed by insolvency proceedings. The debtor benefits through cheaper financing, extended because the financier bears less risk. The other creditors also benefit from the cheaper financing, which decreases the burden on the estate. However, this ex ante benefit to other creditors disappears ex post, when the parties have entered the insolvency process. Unsecured creditors get no benefit in insolvency from asset securitisation, because traditional reorganisations typically redistribute wealth from secured to unsecured creditors (at least with respect to many liquidation priority schemes.) The financiers may still rely on the insolvent bank for servicing and other ancillary activities.

The same result is achieved directly with financial contracts and collateral, in many jurisdictions. As with asset securitisations, this collateral does not have any appreciable firm-specific value in the hands of the insolvent. Furthermore, the ability to liquidate this collateral is essential in

[51] See UNCITRAL, "Alternative approaches to out-of-court insolvency processes," ¶ 24, Working Group A/CN.9/WG.V/WP.55.

preserving systemic liquidity: a special concern for financial institutions. As discussed above, this result is obtained with carve-outs from ordinary insolvency law.

Developments like these, driven by the markets, are likely to increase efficiency and legal certainty by some measures, but may not be equitable according to current national insolvency standards or consistent with financial stability. In unusual instances, such developments can on occasion impair financial stability. The markets, for example, favoured the so-called "walkaway clause" for derivatives contracts in the early 1990s, in which creditors who owed money to a defaulting counterparty after all contracts were netted had the right not to pay. In other words, an insolvent counterparty who would otherwise be "in-the-money" after closeout received nothing. This right, although jointly agreed by the counterparties, was inconsistent with the common goal of insolvency processes to maximise the value of the bankruptcy estate, and conceivably could have perverse incentives for debtors and creditors alike as a troubled firm approached insolvency. The walkaway clause only disappeared when bank regulators refused to recognise netting in computing capital requirements if the netting agreement contained such a clause.

However, such market-driven change is not necessarily inferior or inequitable relative to other approaches. After all, the key legal foundations of modern payment system risk reduction and derivatives netting have received powerful support - and frequently leadership - from market participants. Modern financial markets could not function safely without such foundations. With adequate disclosure, unsecured and secured creditors alike might experience much greater legal certainty relative to the status quo, permitting them to contract with much clearer expectations about the mean and variance of their losses net of recoveries, in the event of default.

G. The Official-centred restructuring

The Official-centred restructuring, when viewed as an emerging legal underpinning of insolvency law, is extremely controversial. In some jurisdictions, it has been long-tried and discredited. In other jurisdictions, it has been extremely successful over the past few decades.

The theoretical promise of Official-centred restructurings is easy to understand. In principle, it can offer the speed and efficiency of market-based restructurings, with far greater flexibility. Unitary decision-makers are far faster than a negotiation process. Liability transfers are possible: another degree of flexibility unavailable in a reorganisation. Finally, the agency costs of a creditor representative are almost certainly greater than the corresponding costs for bureaucrats. Or viewed the other way, an Official-centred restructuring can have most of the flexibility of a Chapter 11-style reorganisation, without the need for protracted negotiations. Many of these theoretical promises have proven themselves in practice, eg in the US Federal Deposit Insurance Corporation receivership, the staple of US bank insolvency law.

However, the practical failure of the Official-centred restructuring in many jurisdictions is also easy to understand. An Official generally has poor incentives to successfully reorganise a firm, compared to financial creditors. An Official generally gets little reward from a successful restructuring, and may be subject to political pressures that are inconsistent with success. It is worth noting that the Federal Deposit Insurance Commission - which restructures US banks - is also the bank insurer, and has a direct financial stake as residual claimant. Official-centred restructurings may also suffer from some informational disadvantages compared to stakeholder-centred reorganisations.[52] These informational disadvantages may be mitigated, however, for supervised institutions.

Official-centred restructurings therefore can be promising if the incentives and institutions are right. But given current incentives and institutions, they appear at best as a speciality, limited to insolvencies of insured and supervised financial institutions. The range of historical experience across countries may provide some valuable lessons about incentives in the insolvency process as many firms become more bank-like in their activities and risk exposures.

H. Forum shopping and legal arbitrage

Two related issues also need consideration: forum shopping" and legal arbitrage. As discussed above, forum shopping exploits the power of an interested party to choose an insolvency forum (and thus insolvency regime) without regarding the interests of other parties. Forum shopping is currently difficult, but may become easier as firms become more global. Legal arbitrage involves choosing different parts of different national legal systems. In doing so, market participants may create a legal framework that does not exist in any national jurisdiction. Often, legal arbitrage is feasible even in the field of insolvency law, where the possibility to exploit this "à la carte" approach is generally limited due to the mandatory nature of insolvency rules.[53] The current level of legal arbitrage may be tolerable, but the trend to increasing arbitrage opportunities is worrisome. Rapid legal evolution promotes arbitrage, especially because the evolution is generally in the direction of greater party autonomy and fewer mandatory rules. Globalisation further increases the salience of this trend.

A degree of forum shopping and legal arbitrage provides incentives for individual countries to adapt their laws to changing conditions and market practices. Taken to an extreme, however, competition among jurisdictions can lead to wasted resources in the form of legal arbitrage and the possibility of efforts to change the insolvency venue in the late stages of distress that could alter the positions of creditors and other stakeholders.

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52 Specifically, incumbent stakeholders may possess private information inaccessible to even a competent and well-motivated Official. Some of this information is related to the value of the firm; other information relates to risk preference. This latter information can be particularly significant in restructurings that transform claims, leading to different results for different general creditors, eg financial debt to equity, or short-dated debt to longer-dated debt. For strategic reasons, these preferences may be best revealed through a negotiation process.

53 For example, some EU initiatives in the field of insolvency law seem to imply some forms of "legal arbitrage", since the law regulating the effects of insolvency on certain kinds of financial contracts is not the law governing the insolvency proceeding, but the law applicable to the transaction as chosen by the parties.

Hence, issues concerning forum shopping and legal arbitrage need to be examined closely to identify an optimal international solution, which should assure transparency of legal rules, certainty of financial transactions, reduction of informational problems and elimination of unintended effects such as moral hazard and cherry-picking.

APPENDIX A:

CROSS-BORDER ASPECTS OF INSOLVENCY

CROSS-BORDER ASPECTS OF INSOLVENCY

Table of contents

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.[1] "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."[2]

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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1 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).

2 'Guide to enactment of the UNCITRAL Model Law on cross-border insolvency', A/CN9/442 (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[3] (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.

[3] 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,[4] thus causing a chain reaction and widespread failures and the realisation of systemic risk.[5] 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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4 See Viral Acharya, *A Theory of systemic risk and design of prudential bank regulation*, p 1.

5 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[6] (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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[6] 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,[7] 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

[7] 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.[8]

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.[9] With reference to

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8 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).

9 Final report of the follow-up group on incentives to foster implementation of standards, 11 September 2001, p 8, at 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.[10] 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,[11] 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".[12] 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 Bustamente 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).

10 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.

11 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.

12 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".[13]

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).[14] 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).[15] 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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[13] Wood, *op cit*, p 293.

[14] The UNCITRAL Model Law was adopted by the United Nations Commission on International Trade Law at its 30th session in Vienna, Austria, in May1997.

[15] 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."[16]

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.[17] 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.[18] 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.[19] Furthermore, the Model Law provides guidelines concerning the recognition of foreign proceedings and the consequences of such recognition.[20] Rules on cooperation with foreign courts and representatives are set out, authorising courts and competent authorities in the enacting state to seek assistance abroad.[21] 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.[22] The

[16] 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.

[17] Article 1 (2) of the UNCITRAL Model Law.

[18] Article-by-article comment on the UNCITRAL Model Law, Article 1 (2).

[19] Articles 9-14 of the UNCITRAL Model Law.

[20] Articles 15-24 of the UNCITRAL Model Law.

[21] Articles 25-27 of the UNCITRAL Model Law.

[22] 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.[23]

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[24] 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)[25] may affect the nature and scope of the relief accorded to the foreign representative.[26]

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."[27]

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

[23] Article 20 (2) of the UNCITRAL Model Law.

[24] 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.

[25] Article 2 (c) of the UNCITRAL Model Law.

[26] See, for example, Article 19 (4) of the UNCITRAL Model Law.

[27] 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.[28] 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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[28] 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 re-organisation 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".[29] 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

[29] 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 […]."[30]

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."[31]

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

[30] Devos op cit, pp 321ff.

[31] 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."[32]

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

[32] 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.[33] 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.[34] 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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[33] Article 9 (2) of the Settlement Finality Directive.

[34] 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[35] and Japan[36] 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).[37] 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.[38]

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[35] 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 contacts*. 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.

[36] 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).

[37] See the outcome of the contract enforceability survey.

[38] 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.[39] 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,

[39] 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.[40] 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 […]."[41]

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.[42] 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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40 For country specific examples, see Wood, *op cit*, p 179.

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

42 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[43] (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[44] (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[45] (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,[46] 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.[47] 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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[43] OJ L 160, 30.6.2000, p 1.

[44] OJ L 110, 20.4.2001, p 28.

[45] OJ L 125, 5.5.2001, p 15.

[46] 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.

[47] 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").[48] 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."[49] The Insolvency Regulation replaces a number of existing bilateral conventions.[50] 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.[51] 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.[52] The Regulation also provides for the possibility under certain circumstances to open secondary insolvency proceedings.[53] 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.[54]

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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[48] "Forum shopping" may also entail the choice of law applicable to a legal entity (lex corporationis) 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).

[49] Article 1.1 of the Insolvency Regulation.

[50] Article 44 of the Insolvency Regulation.

[51] Article 3.1 of the Insolvency Regulation.

[52] See Chapter II of the Insolvency Regulation.

[53] See Chapter III of the Insolvency Regulation.

[54] 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.[55] 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.[56] 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.[57] 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.[58] 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.[59] Moreover, the Winding-up Directive for

[55] Article 7 of the Settlement Finality Directive.

[56] Article 8 of the Settlement Finality Directive.

[57] Article 9 (1) of the Settlement Finality Directive.

[58] Article 9 (2) of the Settlement Finality Directive.

[59] 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.[60]

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).[61]

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.[62]

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.[63] 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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60 See Recitals 25 and 26 of the Winding-up Directive for credit institutions.

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

62 Article 10 of the Winding-up Directive for credit institutions.

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

their domicile in the home member state or in another member state.[64] 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.[65]

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[66] 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.[67] 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.[68]

3. Netting agreements shall be governed solely by the law of the contract which governs such agreements.[69] The same principle applies to repurchase agreements.[70]

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.[71]

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64 Article 16 of the Winding-up Directive for credit institutions.

65 Article 19 of the Winding-up Directive for credit institutions.

66 Article 10 of the Winding-up Directive for credit institutions.

67 Article 21 of the Winding-up Directive for credit institutions.

68 Article 23 of the Winding-up Directive for credit institutions.

69 Article 25 of the Winding-up Directive for credit institutions.

70 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.[72] In this regard, such proceedings differ from the insolvency procedures under the Royal Decree Law 267 of 16 March 1942 (the Bankruptcy Law),[73] where the ordinary judicial

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71 Article 27 of the Winding-up directive for credit institutions.

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

73 he 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.[74]

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.[75]

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 (Societa di Investimento a Capitale Variabile).

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

75 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.[76] 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[77] 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[78] 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[79] 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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[76] Wet van 30 September 1893, Stb. 140, op het faillissement en de surséance van betaling, zoals die wet nader is gewijzigd.

[77] Burgerlijk Wetboek.

[78] Wet toezicht kredietwezen 1992.

[79] 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[80] 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[81] 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

80 *Comfin* [1995] NJ, 542.

81 *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[82] 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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82 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[83] 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.[84]

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

[84] *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 was 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.[85] 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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[85] 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.[1]

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

	IT	JP	NL	UK	US
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

[1] 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[2], 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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2 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.[3]

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

[3] 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[4] and a summary of responses relating to the specified jurisdictions is set out in Appendix 1.

[4] 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[5] 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,[6] the realisation of collateral (whether provided under a security interest or an absolute transfer of title mechanism)[7] 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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5 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.

6 "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.

7 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 "carvedout" 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.[8]

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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[8] 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[9] 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.

[9] 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

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

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

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 form 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.

xliii 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).

xlix 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.[1] 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,[2] the realisation of collateral (whether provided under a security interest or an absolute transfer of title mechanism)[3] and the finality of settlement of payments and transfers of securities pursuant to financial contracts.

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1 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.

2 "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.

3 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).[4]

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

[4] 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,[5] 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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[5] "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)?[6]

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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[6] 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?[7]

[7] 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:

BIBLIOGRAPHY

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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.

<u>Bulk liquidation</u>: 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".)

<u>Chapter 11-style reorganisation</u>: 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.

<u>Comity</u>: 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.

<u>Composition</u>: 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.

<u>Cram-down</u>: 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.)

<u>Deadweight loss (cost)</u>: 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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