EUROPEAN CENTRAL BANK

# CROSS-BORDER ASPECTS OF INSOLVENCY PROCEEDINGS FOR CREDIT INSTITUTIONS – A LEGAL PERSPECTIVE

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## 1. Insolvency – Risks and cross-border issues

There are a number of potential problems and risks connected with the insolvency of financial institutions, 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**. 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[1] (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.

The failure to settle financial transactions is an example of an event which may lead to **liquidity problems**. However, there are other reasons for a lack of liquidity within a particular country, even when its economic situation 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 set-up 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 the so-called **systemic risk**. It is generally recognised that one bank's failure

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[1] OJ L 166, 11.06.1998, p. 45.

may lead to the failure of many banks,[2] thus causing a chain reaction and widespread failures and the realisation of systemic risk.[3] 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.

However, 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

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2 See Viral Acharya, A Theory of Systemic Risk and Design of Prudential Bank Regulation, at p. 1.

3 "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, Annual Report, 1993/1994, at p. 177.

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 conected will need to provide clear answers to the question of which country the collateral taker has to look in order to find the laws aplicable 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 re-use collateral received under a pledge agreement). This area includes insolvency set-off and other netting and close-out arrangements intended to take effect in case of insolvency. In this context, it may be mentioned that the current European legislative proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements[4] (the proposed 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.

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[4] Proposal COM (2001) 168 final of 27 March 2001.

## 2. International rules and sources of law

There are different sources of law which play a role in relation to cross-border aspects of insolvency cases. 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 EU; (iv) private international law; (v) recognised principles of law in the field of cross-border insolvencies; and (vi) comity of law.

### 2.1 International treaties and conventions

In view of the many issues that can arise due to conflicting insolvency laws in different jurisdiction, insolvency treaties between countries have a rather long history,[5] 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".[6] From such an inventory, it is apparent that none of the existing treaties or conventions have a geographic scope wide enough to address the problems discussed in this report. Only a few examples can be given of multilateral treaties with a slightly more extended coverage, namely 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 countries which share similar attitudes to insolvency policies and hence have confidence in the suitability of each other's legal systems."[7]

### 2.2 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

[5] 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 Law and Practise of International Finance – Principles of International Insolvency, Philip R Wood, 1995, at p. 291.

[6] See Chapter 17 on International Insolvency Treaties in Law and Practise of International Finance – Principles of International Insolvency, Philip R Wood, 1995.

[7] Law and Practise of International Finance – Principles of International Insolvency, Philip R Wood, 1995 at p. 293.

Model Law).[8] 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).[9] 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 co-operation 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;
(6) providing for court jurisdiction and establishing rules for coordination where an insolvency proceeding in the enacting state is taking place concurrently with a insolvency proceeding in a foreign; and
(7) establishing rules for coordination 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."[10]

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

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8 The UNCITRAL Model Law was adopted by the United Nations' Commission on International Trade Law at its 30th session in Vienna, Austria, in May 1997.

9 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.

10 International Bank Insolvencies – A Central Bank's Perspective, Editors M. Giovanoli and G. Heinrich, 1999, Paper by J. Sekolec, The UNCITRAL Model Law on Cross-Border Insolvency, at p.338-339.

instance, banks or insurance companies may be excluded from its scope.[11] 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.[12] 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.[13] Furthermore, the Model Law provides guidelines concerning the recognition of foreign proceedings and the consequences of such recognition.[14] Rules on co-operation with foreign courts and representatives are set out, authorising courts and competent authorities in the enacting state to seek assistance abroad.[15] 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 co-ordinate 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] The 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*.[17]

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 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 take place in the country where the debtor has its

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

[12] Article-by-Article comment to the UNCITRAL Model Law: Article 1(2).

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

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

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

[16] Articles 28-32 of the UNCITRAL Model Law.

centre of main interests)[18] may affect the nature and scope of the relief accorded to the foreign representative.[19]

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."[20]

## 2.3 The new EU regime on cross-border insolvency

In addition, the new legal regime on insolvency within the EU 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 legal and institutional framework of the EU. 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 two directives have been adopted concerning the winding-up

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

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

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

[20] Smart, Cross-Border Insolvency, 1998, at p.7.

and reorganisation of insurance undertakings and of credit institutions.[21] These recently adopted EU-wide legal acts will ensure the mutual recognition and co-ordination of national insolvency proceedings, although insolvency laws will still generally fall within the national competence of the Member States.

## 2.4 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?; and (c) is a judgement or decision by a judicial authority recognized 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 recognized 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 extra-territorial effect, although this may not be recognized in the jurisdiction where extra territoriality is supposed to take effect.

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[21] Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings (the EU Insolvency Regulation), OJ L 160, 30.6.2000, p. 1-18. The EU Insolvency Regulation will be 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 re-organisation and winding-up of insurance undertakings[21] (the EU Winding-up Directive for insurance undertakings), OJ L 110,20.4.2001, p. 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, pp.15-23. The time frame for Member States to implement the Winding-up Directive for credit institutions is by 5 May 2004.

## 2.5 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 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".[22] 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

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22 Included in International Bank Insolvencies – A Central Bank Perspective, Editors M. Giovanoli and G. Heinrich, 1999, at p.311.

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 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 […]."[23]

Another 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 hotch-pot 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

[23] International Bank Insolvencies – A Central Bank Perspective, Editors M. Giovanoli and G. Heinrich, 1999, Paper by D. Devos on Specific Cross-Border Problems Regarding Bank Insolvencies and European Harmonization Efforts, at p.321 – 323.

100 abroad, he should not receive any dividends locally until other creditors have received 30 locally."[24]

### 2.6 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 extra-territorial 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 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."[25]

## 3. The new EU legal regime for cross-border insolvency

### 3.1 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. The aim has been to implement these general principles in relation to the 15 EU Member States, and each legal act that has been adopted reflects this intention. These are a regulation on insolvency proceedings and two directives providing specific rules concerning respectively the winding-up and reorganisation of insurance undertakings and of credit institutions:

1. Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings[26] (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[27] (the Winding-up Directive for insurance undertakings);

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[24] Law and Practise of International Finance – Principles of International Insolvency, Philip R Wood, 1995, at p. 271-272.

[25] Observed by Millet LJ 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, 1998, at p. 328.

[26] OJ L 160, 30.6.2000, p. 1.

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

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[28] (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 EU 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 co-ordination of these procedures by Member States.

The Insolvency Regulation will be effective and directly applicable in all EU Member States on 31 May 2002 without any additional national legislative measures. 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.

The main objective of the **Insolvency Regulation** is to ensure that cross-border insolvency proceedings operate efficiently and effectively within the EU. 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 (so-called 'forum shopping'). 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."[29] The Insolvency Regulation replaces a number of existing bilateral conventions.[30] 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

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

[29] Article 1.1 of the Insolvency Regulation.

[30] Article 44 of the Insolvency Regulation.

open insolvency proceedings.[31] 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.[32] The Regulation also provides the possibility under certain circumstances to open secondary insolvency proceedings.[33] 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.[34]

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 EU, including branches of such undertakings having their head office outside the EU. In the case that an insurance undertaking with branches in other EU Member States becomes insolvent, the entity 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. Co-ordinated 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 inter-related 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. In addition, it applies to the branches of a credit institution having a head office outside the EU, where that institution has branches in at least two EU Member States. It provides that the reorganisation and winding-up of credit institutions shall take place on the basis of

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[31] Article 3.1 of the Insolvency Regulation.

[32] See Chapter II of the Insolvency Regulation.

[33] See Chapter III of the Insolvency Regulation.

[34] Article 6 of the Insolvency Regulation.

the principle of the unity and universality of the proceedings by applying the law of the institution's Member State of origin (the home Member State). The Directive covers reorganisation measures, winding-up proceedings and contains some provisions common to these two arrangements. For instance, issues related to applicable law are covered in both cases. Moreover, the Directive includes some provisions on consultation and information sharing between home and host competent authorities as well as on the duty to inform creditors (for instance, notification of decisions and publication in the Official Journal of the European Communities).

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.[35] 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.[36] 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.[37] 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.[38] 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.[39] Moreover, the Winding-up Directive for 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.[40]

[35] Article 7 of the Settlement Finality Directive.

[36] Article 8 of the Settlement Finality Directive.

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

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

[39] See Recital 27 and Article 9 of the EU Insolvency Regulation.

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

In the context of the present seminar, the most important of these new EU legal acts is the Winding-up Directive for credit institutions and, consequently, the main rules and provisions of this Directive are given some further consideration in the following.

### 3.2 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).[41]

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 co-operation 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.[42]

In order to provide for clarity and transparency in the insolvency proceedings, the authorities in the home Member State need to inform without delay the authorities of host Member States 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.[43] The provisions of the Directive on the right

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[41] Article 9(1) of the Winding-up Directive for credit institutions.

[42] Article 10 of the Winding-up Directive for credit institutions.

[43] Article 9(2) of the Winding-up Directive for credit institutions.

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 their domicile in the home Member State or in another Member State.[44] 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.[45]

### 3.3 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[46] 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 re* 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.[47] 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.[48]

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

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

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

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

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

3. Netting agreements shall be governed solely by the law of the contract which governs such agreements.[49] The same principle applies to repurchase agreements.[50]
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.[51]

### 3.4 The EU insolvency regime in an international context

The EU legislation on cross-border insolvency issues provides for a harmonised legal framework and legal certainty with regard to the country where insolvency proceedings may be commenced and the law applicable to such proceedings in any of the 15 countries. 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 would 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 European branches of non-European entities would, furthermore, seem to enhance predictability and legal certainty for non-European, as well as European, creditors of such financial institutions that may be affected by this rule.

## 4. Some specific issues related to international insolvency proceedings

### 4.1 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 EU. As against countries outside the EU, 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.

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[49] Article 25 of the Winding-up Directive for credit institutions.

[50] Article 26 of the Winding-up Directive for credit institutions.

[51] Article 27 of the Winding-up Directive for credit institutions.

As far as recognition of foreign insolvency proceedings in general is concerned (i.e. apart from recognition within the EU 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 generally is 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 judgement is to be recognised or not. This would make the recognition of foreign insolvency proceedings conditional on the prerequisites for recognition and enforcement in 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 judgement already given in that state. Accordingly, the competent authorities in many countries recognise foreign insolvency proceedings and judgements 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.

## 4.2 Enforceability of financial contracts

When parties to 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 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 EU and its individual Member States.

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 EU, the Settlement Finality Directive contains rules that aim to create legal certainty in this respect.[52] 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.[53] 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.

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

[53] 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.

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 (e.g. 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 proposed draft EU legislation in this area (the proposed 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 proposed 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 proposed Collateral Directive, which is also suggested to cover "top-up" collateral, i.e. additional collateral provided as a result of changes in the market value of collateral given (or other events specified in the collateral arrangement). The proposed 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 on the 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 (i.e. the law of the home Member State of the insolvent entity), but instead to the *lex contractus* of the agreement 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 EU, therefore, this provision will address the issue and be applicable in any insolvency proceedings taking place. Hence, it should be quite 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.

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 set-off provisions are generally included in the insolvency laws of a particular country and have mandatory application.

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

In some jurisdictions, the insolvency of credit institutions is regulated in the banking laws as a specific sub-set 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 co-operation 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.

### 4.4 Cross-border dimensions of liquidation and re-organisation

One fundamental question at the outset of major insolvency cases is whether a rescue attempt should be undertaken through so-called 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, could lead to contrary conclusions on 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.[54] Again, today's solution to this potential problem area can be found under the concept of informal co-operation and co-ordination 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 […]."[55]

## 5. Concluding remarks

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 there exist rules they do not address the cross-border dimension or, with the exception of the EU, 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 make use of its provisions. Accordingly, the legal regimes are basically national in nature, whilst the cross-border insolvency problems considered in this paper are

[54] For country specific examples, see Law and Practice of International Finance – Principles of International Insolvency, Philip R Wood, 1995, at p. 179.

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.

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, as well as within the EU. However, despite such positive legislative developments, most of them are primarily prepared at a national level and the solution in practice to cross-border issues most often remain based on comity of law and the voluntary co-operation between different national courts and authorities on an ad hoc basis.

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 entities with a registered office or establishment in the EU shall be the laws of its home state. This new 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. 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.

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[55] Blair J in Re Olympia and York Developments Ltd., (1996) 29 O.R. (3d) 626, at 633. See Smart, Cross-Border Insolvency, 1998, at p. 331.