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Trans-border Bank Insolvency: A Generation Later

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Introduction

Hans-Jochem Luer's single most noted participation in the field of international transactions was his role in the Herstatt Bank litigation. Therefore, it seems fitting to honor him with a contribution to the subject of cross-border bank insolvency, especially considering that recent developments in the European Union and in the United States now implicate issues of federal-state relations that were not yet on the horizon a generation ago. This paper will focus in particular on the US side of the issue, even if it is clear that no purely national discussion can or should ignore the EU Directives in the field.

The task is made easier by the appearance of strong theoretical and empirical studies in recent years, in particular the comparative studies of *Hüpkes*¹ and of *Baxter et al.*² The contribution of spectacular failures and sins during the past decades to the enrichment of this literature also should not be overlooked; indeed, already 30 years ago the *Herstatt* case itself became the focus of academic and professional analysis,³ and the BCCI debacle⁴ provided both a rich jurisprudence and exhaustive commentary. In addition, international efforts at creating more uniform supervisory and prudential treatment of bank solvency and rehabilitation have led to important reforms, especially in the form of the Basle Concordats.⁵ These and related reforms have created a more uniform as well as a higher "capitalization floor" that reduces the risk of bank failure due to inadequate capitalization. They also have created better coordination of national supervision of globally active banking institutions,⁶ improving the previously fragmentary and

¹ Eva Hüpkes, *The Legal Aspects of Bank Insolvency* (the Hague: Kluwer, 2000).

² Thomas Baxter, Joyce Hansen & Joseph Sommer, Two Cheers for Territoriality: An Essay on International Bank Insolvency Law, 78 Am. Bankr. L. J. 57 (2004).

³ See, e.g., the early and influential discussion in Kurt Nadelmann, Rehabilitating International Bankruptcy Law: Lessons Taught by Herstatt and Company, 52 NYU L. Rev. 1 (1977).

⁴ In lieu of extended citations to the many cases and commentaries on this notorious case, see the "wrapup" decision, *In re BCCI Holding U.S.*, 69 F.Supp.2d 36 (D.D.C. 1999)

⁵ Now consolidated (including the 2004 Basel II Revised Framework) in International Convergence of Capital Measurement and Capital Standards: A Revised Framework, available at <http://www.bis.org/publ/bcbs111.htm> (last visited August 24, 2007).

⁶ See most recently Bank for International Settlements, Basel Committee on Banking Supervision, "Home-host information sharing for effective Basel II implementation" June 2006, available at <http://www.bis.org/publ/bcbs125.pdf> (last visited Sept. 10, 2007).

inadequate national solutions to the special dangers posed by the insolvency of financial institutions, with their essential leveraged nature.⁷ Finally, at the transnational level, they have largely eliminated the unpredictable risks associated with daily payments and securities streams that made the Herstatt collapse the systemic shock it was.⁸

In a sense, the mitigation of systemic interbank risks relativizes the special nature of bank insolvency. The spread of governmentally provided (and required) deposit insurance reduces the risk of bank runs and their effect on credit collapses, and the more effective use of reserve requirements and of bank access to governmental short-term credit facilities aims for the same benefits in the context of both national and coordinated monetary policies. While the state interest in its deposit-insurance system and in its system of credit windows will remain unique features of bank insolvency correction, the modern regulatory framework permits a new discussion of the respective roles of standard and of bank cross-border insolvency regimes.⁹

Thus much of the groundwork for a further discussion has been laid. New and relatively unexplored are some implications of state-federal relations generated by recent legislative revisions in the field of cross-border bankruptcy generally and of cross-border financial-institution bankruptcy in particular. A currently pending case, *In re Deposit Insurance Agency*,¹⁰ offers an appropriate entry point to this field, and analyzing its implications will be the principal contribution of this paper. While the discussion, as mentioned, concentrates on the US situation, it may be of some relevance to current efforts to improve the treatment of the reorganization and liquidation of financial institutions within the EU system.¹¹

⁷ Though undoubtedly there always will be room for improvement on this score. The unhappiness of US regulators with the absence of timely information from their Japanese counterparts in the Daiwa Bank unlawful-trading scandal is a useful reminder of the need to maintain the early and open communication on which the cooperative system is based. See “Foreign Bank Supervision and the Daiwa Bank,” Hearing of the Subcommittee on Financial Institutions and Consumer Credit of the House of Representatives Committee on Banking and Financial Services, 104th Cong. 1st Sess., Serial No. 104-40 (1996).

⁸ See *Delbrueck & Co. v. Manufacturers Hanover Trust Co.*, 609 F.2d 1047 (2d Cir. 1979), involving the finality of interbank CHIPS transfers during the day of Herstatt’s collapse.

⁹ This discussion will not include what may be the most important issue faced by any regulation of financial institutions; namely, the impact of new financial contracts, especially derivative instruments, and new financial players, on systemic risk. A major step towards capturing these elements is provided in Title IX of the 2005 revisions of the U.S. Bankruptcy Code; for an excellent introduction to the problem and the role of these reforms, see FDIC [Michael Krimminger], FYI: An Update on Emerging Issues in Banking, October 11, 2005 (“Adjusting the Rules: What Bankruptcy Reform Will Mean for Financial Market Contracts”), available at www.fdic.gov/bank/analytical/fyi/2005/101105fyi.html (last visited Sep. 11, 2007).

¹⁰ 482 F.3d 612 (2d Cir. 2007). Another case, involving the former Yugoslav Export and Credit Bank, *In re Milovanovic*, 357 Bank. Rpt’r. 250 (S.D.N.Y. 2006) also is wending its way through the US judicial system.

¹¹ See European Commission, Internal Market and Services DG, “Public consultation on the reorganization and winding-up of credit institutions (May 2007), available at xxx.

I The Current US Legal Regime in the Insolvency Context

A. The Mix of State and Federal Supervision

Foreign banks, as is well known, need not form US subsidiaries to operate here. They may open branches, agencies, or representative offices upon observing either federal or state licensing procedures. While federal charters for branches and agencies are available, most foreign banks apply for state charters, overwhelmingly in New York with California the second most frequent state of application. As a result, with two exceptions¹² it is therefore state, not federal, insolvency regimes that apply to their or their home entities' financial difficulties. The principal legislation applicable in this situation is that of New York.

The grounds for the intervention of the state superintendent into the affairs of a domestic banking organization include both positive-law violations and a variety of financial difficulties in both a liquidity and a capital-impairment sense.¹³ These grounds then are applicable to the affairs of the New York offices of foreign banks, as Banking Code Section 606(4) makes clear:

“The superintendent may also...take possession of the business and property in this state of any foreign banking corporation that has been licensed [in New York]...upon...finding that any of the reasons enumerated [for domestic banks] exist with respect to such corporation or that it is in liquidation at its domicile or elsewhere or that there is reason to doubt its ability or willingness to pay in full the claims of the [local] creditors....”

The superintendent then shall “ring-fence” these local assets and use them to pay, in full, the claims, but only the claims “arising out of transactions had by them with its New York [agency or branch]”; further, inter-enterprise claims such as loans from the home organization to the local unit are not to be paid.¹⁴

The justification claimed for this absolute preference of all, not only financial-sector, local claims, secured or unsecured, is the policy of permitting the local operation of

¹² The first exception concerns the rare case of a branch or agency grandfathered into eligibility to insure retail deposits and thus subject to federal regulation of its financial distress; see the explanation at **xxx** below. The second, more common exception concerns branches or agencies that have utilized the Federal Reserve Bank's various credit facilities, thus becoming subject to federal regulation because of that governmental credit position; see the explanation at **xxx** below.

¹³ Banking Code Section 606(1).

¹⁴ Section 606(4)(a):.... “[Excluded from payment are] amounts due and other liabilities to other offices, agencies or branches of, and affiliates of, such foreign banking corporation.” “Other offices” is understood to include loans, etc., made by the foreign banking corporation directly.

foreign banks in unincorporated rather than incorporated-subsidary form.¹⁵ The funds required by the licensing authority to be made available to the local branch or agency, in other words, are deemed the equivalent of whatever funds a locally incorporated subsidiary would own, and thus subject to non-owner claims. But it is not only the required capitalization: All assets of the local unit, whether stemming from original capital, operating earnings, and claims against (i.e, loans made to) third parties are subject to first use to satisfy a variety of local claimants – the so-called ring-fencing.¹⁶

It is apparent that in fact this local preference goes beyond what would in fact, and in law, apply in the case of locally incorporated subsidiaries of foreign parent corporations in non-banking/financial sectors.¹⁷ Not only is the automatic exclusion of intra-enterprise loans and claims a unique feature of the described regime; more significant is the fact that ordinary cross-border bankruptcy proceedings, at least as a discretionary matter, permit ancillary administration of local assets by the home bankruptcy trustee, with the result that local claims against the local subsidiary may have to be presented in and subject to the foreign principal bankruptcy proceedings.¹⁸ This suggests that other considerations need to be put in play if this special regime is to be justified; and those considerations, of course, derive from the special and especially sensitive nature of the banking sector.

A. General Considerations

The reasons why “banks are different” are well-known and well-rehearsed in the theoretical literature, even as rapid changes in the global financial markets and global business practices challenge some of the policy bases underlying special insolvency regimes for banks. At the national level, the increasing role non-bank institutions play in the provision of credit to the firms of the manufacturing and service sectors and the increasing location of traditional banks within holding-company structures that also own non-bank entities complicate and to some degree make more debatable the separate-regime argument. At the transnational level, while global banks are not a new phenomenon, their increase thanks to the liberalization of the nationally fenced playing

¹⁵ This indeed is one of the main justifications for both sector-specific insolvency processes and ring-fencing generally accepted. See its role as emphasized by the Federal Reserve Bank of New York in its *amicus curiae* brief in the *Insurance Deposit Agency* case, n. xxx below, citing U.S. Department of Treasury and Board of Governors of the Federal Reserve System, “Subsidiary Requirement Study” (1992),.

¹⁶ The unclaimed balance of the local assets first are to be transferred then are first to be applied to satisfy unpaid claims against other US units of the bank, and then are to be turned over to the “principal office of such foreign banking corporation, or to the duly appointed domiciliary liquidator or receiver of that foreign banking corporation.” Section 606(4)(b).

¹⁷ And, for that matter, to some non-banking financial sectors, giving rise to a problem not discussed here – that of the distortion of the level playing field to the advantage of non-bank institutions. The current US debate over the venue of insolvency proceedings for unregulated hedge funds is a good example.

¹⁸ The current US version of this universally recognized approach to territoriality versus universality in cross-border insolvency situations is the new Chapter 15 of the Bankruptcy Reform Act of 2005, codified as 12 U.S.C. §§ 1501ff.

fields of an earlier day brings new importance to the cross-border aspects of insolvency regulation, if only as a subset of the coordination of bank supervision generally. And by analogy to the changing competitive arena of the national level, the arrival of e-banking with all the cyberspace problems of jurisdiction and conflict of laws that this phenomenon has created across all sectors further complicates the scene.

For present purposes, putting aside the political comfort factor of deposit insurance, it is the availability of short and immediately repaid loans –whether provided through interbank credits or by national public institutions such as central banks or, in the US, the Federal Deposit Insurance Corporation and the federal reserve system respectively – that embodies the principal precautionary response to bank liquidity problems. Those features are also the principal reasons why the handling of those problems, including potential insolvency as the extreme case, are matters of public policy that differ from those informing the treatment of “ordinary” business insolvency. In a federal system, that may implicate conflicts between different levels of government: The same level may not be charged with administration of both insolvency regimes. In the global context jurisdictional competition and conflict between “home” and “host” supervisory regimes also may occur.

Of course these policy issues have an extremely practical consequence. They typically lead to the “ring-fencing” of all local assets in the host country, and thus in turn to the ability of creditors of and claimants against the local entity to satisfy their claims without having to present them in the principal home-country proceeding and thus in competition with home-country creditors and claimants. That in turn allows the question, whether the nature of local supervision/regulation of banks logically or necessarily requires local claimant preference or whether the more discretionary approach embodied in the new Chapter XV of the general bankruptcy laws could function in this sector as well.

It is surprising that this is a matter of first impression; yet no previous case has resolved the jurisdictional conflict between federal bankruptcy courts and federal and state banking supervisors over the local subsidiaries or (more realistically) branches of a foreign banking institution. Jurisdiction over the passive local assets of a foreign bank, such as a correspondent-bank account, is another and more straightforward matter, as the federal appellate court said in the *Israel-British Bank* case more than 30 years ago:¹⁹

“We can find no convincing reason why a foreign banking corporation, not licensed to do business in the United States, conducting no semblance of a banking business here, and not under the regulatory supervision of any state or federal agency, should not qualify for the benefits of the Act as a voluntary bankrupt....If IBB had been licensed to conduct a banking business in New York and had taken deposits here, it could be argued with some reason that the State of New York, having assumed supervision, should control the liquidation of its

¹⁹ Matter of *Israel-British Bank* (London), Limited, 536 F.2d 509 (2d Cir. 1976) (emphasis added).

Assets in New York rather than the Bankruptcy Court”²⁰

The question mooted by the negative inference contained in that quotation, however, long unsettled, now is on the way to resolution in the mentioned litigation.²¹ Two Yugoslav banks, Jugobanka and Beogradska Banka, had received state licenses to operate domestic agencies²² in New York. Their later financial difficulties did not – for a change – result from mismanagement but from the Balkan conflicts and in particular from the US Executive Orders freezing their local assets (in particular those held in other New York banks) and ordering the closure of their US offices. A decade later the DIA, as liquidator of these banks in the former Yugoslavia, began ancillary insolvency proceedings in New York and asked the local US Bankruptcy Court for a so-called Section 304 order to recover the local (US) assets in order to include them in the home-country insolvency proceedings.²³

The important substantive issue raised in this litigation – the arguable exclusion of banks and related financial institutions from the standard bankruptcy process (including its cross-border pendant) – was deferred because of a unique and in our context less important issue involving the asserted immunity of state offices from the jurisdiction of the federal courts. That issue now has been decided against the immunity claim, and so the case has been remanded for consideration of the substantive point.

That point will be resolved under the now superseded 1978 Bankruptcy Act, but for present purposes it is the resolution of this issue under the new Chapter 15 of the 2005 Bankruptcy Act, setting out a more holistic regime for general cross-border bankruptcy proceedings, which will be used in the discussion that follows. The arguments that need airing and form the basis of the following discussion are those in favor of keeping the supervision of banking institutions – including potential insolvency reorganization and liquidation consequences – separate from non-banking bankruptcy administration even in today’s world of e-banking, universal banking, and non-bank credit origination and facilitation.

B. Is Banking Special?

²⁰ Id. at 515. The new Chapter XV may, however, be interpreted not only to eliminate the eligible-debtor qualification (that already was a feature of the 1978 Act) but even to preclude a foreign liquidator’s right to commence an ancillary proceeding in the US to take charge of local assets. That issue is further discussed below.

²¹ In re Deposit Insurance Agency, *supra* n. 8.

²² Not branches; the distinction, however, is of minor significance in terms of host (US) country regulation of either form.

²³ Section 304, enacted in 1978, now has been superseded by Chapter 15. The possible role of the new statute for the jurisdictional rivalry of federal bankruptcy courts and state (and federal) bank regulators is discussed below.

1. A Digression Into Non-Insolvency Regulatory Concerns

First, however, some important definitional issues and some important practical considerations need to be presented, if only to be excluded from what follows. Since it is the local deposit-taking and local lending functions that justify the special treatment of banks, activities not involving those functions are excluded from the following discussion. In formal terms, that means that the activities of local representative offices of foreign banks are not of primary concern here. That their activities can generate international jurisdictional issues, including those of judicial versus regulatory competence to handle their affairs, is clear; indeed, most US litigation involving local assets of foreign banks falls under that category. That same litigation has at least in the appropriate situations also upheld the right of the foreign bank liquidator to use the US bankruptcy regime in order to claim the local assets and relegate local creditors in the ancillary jurisdiction to the home forum and its liquidation proceedings.²⁴ In other words, the special regime covering distressed banks and excluding them from the general bankruptcy regime does not apply absent the mentioned policy bases for that special regime.

Also beyond the scope of this discussion is an entire cohort of bank controls bearing not on these institutions' financial distress, whether in the home or host jurisdiction, but on other regulatory policies. Today it is money laundering, including the sensitive case of terrorist financing, that preoccupies the US regulatory authorities, both federal and state. The Comptroller of the Currency in the case of federally chartered local branches of foreign banks, and the Board of Governors of the Federal Reserve System in collaboration with the relevant state supervisory agency in the case of state-chartered branches, frequently identify and pursue violations of the bank secrecy and anti-money laundering programs required under federal statutes and regulations.²⁵ These investigations may result in fines and other sanctions though usually in consent decrees or simple "agreements" requiring the offending bank to comply with these laws and regulations, in particular with the Bank Secrecy Act.²⁶ These proceedings, and their

²⁴ Compare *Israel-British Bank*, supra n. 3, with *In re Koreag, Controle et Revision S.A.*, 961 F.2d 341 (2d Cir. 1992); see generally the later effort to reconcile these holdings in *In re JP Morgan Chase Bank*, 412 F.3d 418 (2d Cir. 2005) depending on the status of the local creditor under local law (e.g., distinguishing property from contract rights).

²⁵ Indeed, these have been important concerns in the case of domestic banks and other financial institutions. For a discussion of one of the most notorious cases, the Riggs National Bank affair, see *In the Matter of Riggs Bank National Association*, Consent Order No. 2003-79, available at www.occ.treas.gov/ftp/eas/ea2003-79.pdf, and fully discussed in Paul L. Lee, *Regulation of Foreign Banks* (4th ed. Supp. 2007) at §1.04, pp. 1-54ff. This study provides an exhaustive review of all federal legislation, regulation, and enforcement activity in this critical sector.

²⁶ See, e.g., *In the Matter of Bangkok Bank Public Company Limited*, a federally chartered branch, as reported in *Lee*, supra n. xxx, at §1.04, pp. 1-65f (Consent Order following cease-and-desist proceedings); Written Agreement by and among Banco de la Nacion Argentina, Federal Reserve Bank of New York and New York State Banking Department, February 2007 ("Agreement" with bank operating a state-chartered branch) (available at <http://www.federalreserve.gov/boarddocs/press/enforcement/20070306/attachment.pdf>).

larger context, also are beyond the scope of this discussion, which now returns to the basic question of regulatory competence.

2. The Jurisdictional Conflict As a Matter of Statutory Interpretation

A first question that presumably will be resolved in the *Deposit Insurance Agency* litigation concerns the question, whether the amendments to the “foreign bank branch” location adopted in the definitional sections of the new Bankruptcy Code themselves resolve the jurisdictional conflict as a straightforward matter of positive statutory law. The version of the Bankruptcy Code at issue in that litigation did not separately identify the US branch or agency of a foreign bank; the 2005 revision does. Whether that revision alone, in purely textual terms, provides the definitive answer to the question of regulatory competence is not clear. The relevant provisions are as follows:

Section 109 – 1978 Version

(a) Notwithstanding any other provision of this section, only a person that... has...a place of business, or property in the United States...may be a debtor under this title.

(b) A person may be a debtor under chapter 7 of this title only if such person is not—

....

(2) a domestic...bank....; or

(3) a foreign...bank...engaged in such business in the United States.

Section 109 -- 2005 Version

(a) Notwithstanding any other provision of this section, only a person that...has...a place of business, or property in the United States, may be a debtor under this title.

(b) A person may be a debtor under chapter 7 of this title only if such person is not---

....

(2) a domestic...bank....; or

(3) ...(B) a foreign bank...*that has a branch or agency (as defined in section 1(b) of the International Banking of 1978) in the United States* .(emphasis added)

The only relevant semi-official commentary to this revision is that of the House of Representatives:

“Section 802(d) amends section 109 of the Bankruptcy Code to permit recognition of foreign proceedings involving...foreign banks which do not have a branch or agency in the United States....While a foreign bank not subject to United States regulation will be eligible for chapter 15 as a consequence of the amendment to section 109..., section 303 prohibits the commencement of a full involuntary proceeding against such foreign bank unless the bank is a debtor in a foreign proceeding.”²⁷

Since a foreign bank involved as a debtor in a foreign proceeding always has been potentially subject to a “full involuntary proceeding”²⁸ in the United States,²⁹ that element of the revision and of this commentary adds nothing to the resolution of the question. Only the negative inference inherent in the addition of the separate subsection (3)(B) of §109 can carry the argument in favor of exclusive jurisdiction of the state banking department (exercised, in appropriate circumstances, concurrently with the Federal Reserve Board and the FDIC). That may be the case, though the counterargument, still in formal terms, is that eligibility to be a debtor – the starting point of §109 -- has not generally been thought to be a barrier to a foreign trustee’s ancillary US proceeding to recover local assets from someone arguably not entitled to them.³⁰

Whatever the resolution of the textual argument, a sound decision needs to be based as well on appropriate policy considerations.

²⁷ House Report (Judiciary Committee) No. 109-31 (Part 1), April 8, 2005, in 4 United States Code Congressional and Administrative News, 109th Congress, First Session, 2005, 88, at 181.

²⁸ “Full” in this context does not refer to primary versus ancillary proceedings.

²⁹ In addition to *Israel-British Bank*, supra n. 3, see, e.g., *In re Banque de Financement*, 568 F.2d 922 (2d Cir. 1977) and *In re JP Morgan Chase Bank*, 412 F.3d 418 (2d Cir. 2005).

³⁰ That position is the basis for the decision of the U.S. District Court in the *Jugobank* litigation, *In re Agency for Deposit Insurance, Rehabilitation, Bankruptcy and Liquidation*, 310 Bank. Rep’ts 793 (S.D.N.Y. 2004), reconsideration den., 313 Bank. Rep’ts 561 (S.D.N.Y. 2004). It derives from a provision in the Bankruptcy Code (of 1978) permitting ancillary proceedings in order to prevent piecemeal distribution and dissipation of the foreign debtor’s US assets. While not directly addressed by the appellate court, the latter’s treatment of the action as not falling under the constitutional grant of state immunity from suit suggests a sympathetic view of the lower court’s ruling:

“Our inquiry concerning [the state immunity question] is limited to whether the alleged violation is a substantial, and not frivolous, one; we need not reach the legal merits of the claim....Here, no argument is presented that the Agency’s claim is frivolous or insubstantial – a doubtful proposition at best, when after thorough and careful briefing on the issue, two federal judges arrived at opposite conclusions.” 482 F.3d at 621.

C. The Case for a Banking Sector-Specific Insolvency Regime

1. Deposit Insurance

Deposit insurance is not the principal issue creating the jurisdictional conflict over the insolvency process in the United States, though it is an important baseline for the new EU regime. Of course, deposit insurance in general is at the end of the day guaranteed by the public fisc. Therefore, a governmental interest in the supervision of banks taking insured deposits is created, if only through the subrogation mechanism that substitutes the Federal Deposit Insurance Corporation for the insured depositor-claimant. This is not a significant feature of the argument in favor of exemption from Chapter XV, however, for two reasons. First, this insurance is rarely utilized – the regulatory system everywhere typically arranges for the transfer of deposits to a successor institution that is in a financial position to honor withdrawals. It is true that the FDIC is both guarantor and receiver of insured banks, and occasionally faces the charge that the conflict of interests inherent in this dual capacity creates liability for damages caused to a bank by its behavior. In any event, both the subrogation claim and the disposition of these unusual debtor-bank complaints properly are a matter of local regulatory concern and thus warrant the application of the sector-specific insolvency regime, including its ring-fencing attribute.³¹

The far more significant reason – practically and analytically -- why deposit insurance is largely irrelevant to the described jurisdictional conflict is the simple fact that with few exceptions the US branches and agencies of foreign banks could not historically and cannot now create insured deposits.³² Only with the enactment of the International Banking Act of 1978,³³³⁴ which while excluding “wholesale” activities of these branches did require insurance for initial deposits under the insurable ceiling, was acceptance of insurable deposits permitted. And that new authority did not last long. The original situation in essence returned after 1991 and the BCCI scandal: The Foreign Bank Supervision Enhancement Act of that year in essence prohibited the offer of small deposit services by these branches and agencies, except for a few banks that had been offering

³¹ Were the FDIC relegated to claim under its subrogated status abroad, this would result in a waiver of its foreign sovereign immunity against counterclaims or cross-complaints for such damaging activity at home. Given the rarity of the actual use of deposit insurance and thus of the FDIC’s subrogated status, however, this aspect of the matter is too far-fetched an argument to weigh in the balance in either direction.

³² See the full review of the historical situation by John Dugan, Peter Flanagan & Jason Albert, “FDIC Insurance and Regulation of U.S. Branches of Foreign Banks,” in *I Regulation of Foreign Banks* (Michael Gruson & Ralph Reisner, eds., 4th ed., 2003) at 333ff.

³³ 12 U.S.C. Secs. 3100ff.

³⁴ Wholesale deposit-taking activity refers to the practice of accepting only initial deposits that because of their amount do not qualify for deposit insurance. See the present statement of this activity in 12 U.S.C. Sec. 3104(c)(1).

such services and for that reason were “grandfathered” into continuation of that authority.³⁵

In short, if there are reasons for putting the unique US combination of state and federal banking authorities in charge of the local insolvency proceedings of foreign banks, and allowing the ring-fencing of local assets,³⁶ they have to be disaggregated and identified specifically. In that endeavor, it is useful first to consider the classes of claimants; that is, their private or their governmental status. Then the non-claimant reasons for this separate status need to be identified; that is, the classic problem of immediate and flexible handling of bank illiquidity before the arrival of full-blown insolvency on the one hand, and the implications for monetary policy that might arise were the general Chapter XV process privileged over the regulatory process on the other. Those efforts form the basis of what follows.

2. The Claimants Against the Local Branch

a. The Private Claimant

The few insured depositors aside, it is the wholesale deposit-seeking activity of the local branches of foreign banks that generates one specific set of claimants in case of the home bank’s or the banking conglomerate’s insolvency. These claimants cannot offer a reason for the protection ring-fencing provides them that is any more compelling than that of any local claimant in a non-bank insolvency situation. Chapter XV, like its predecessor Section 304, does not mandate relegation of local claimants to the home bankruptcy administration; thus it is fair to inquire whether its criteria for the exercise of the court’s discretion are adaptable to bank insolvencies. If anything, the particular weight US courts pay to the comity/reciprocity element of the catalogue³⁷ might weigh in favor of deference to the home bankruptcy process, since especially within the EU the universal

³⁵ 12 U.S.C. Sec. 3104(d). This development is discussed in Dugan et al., *supra* n. 30. They report that as of October 2002 only 18 such grandfathered branches continued to enjoy this possibility (*id.* at 336 n. 20). The Federal Reserve Board’s Structure and Call Report Data for U.S. Offices of Foreign Entities, as of March 31, 2007, identifies 11, though some have separate authority for branches under different regional Federal Reserve Bank supervision. Of the German banks, Deutsche Bank and Dresdner Bank are included.

It is likely that except for a few foreign-bank branches catering to customers identified with the home country (e.g., India), most enjoying this status nonetheless focus on wholesale rather than on insurable deposits to the extent they seek local deposits at all. For an earlier analysis of this situation, see Henry Terrell, Robert Dohner & Barbara Lowrey, “The Activities of Japanese Banks in the United Kingdom and in the United States,” 76 Fed. Res. Bull. 39 (1990).

³⁶ The two Yugoslav banks involved in the present litigation have approximately \$100,000,000 of assets in, and frozen in, the United States. Discussions with Agency counsel suggest that much of that sum was transferred from Yugoslavia to cover significant trade-financing transactions (the facts have not yet been developed in the litigation because of federal sequestration of the New York agencies’ documents as part of the freezing order).

³⁷ See Hannah Buxbaum, Rethinking International Insolvency: The Neglected Role of Choice-of-Law Rules and theory, 36 Stan. J. Int’l L. 23 (2000), *esp.* at 42.

principle of bankruptcy administration is especially well ensconced and honored in bankruptcy practice.

These non-insured depositor/claimants aside, a second principal private source of local branch liabilities is the domestic and to some extent the external interbank market these branches may tap to support their own lending activities.³⁸ That market is essentially a day or overnight market, and to some extent is protected by post-*Herstatt* netting and finality rules. Nevertheless, to the extent lending banks, especially US lending banks, might be trapped in an unprotected situation, a systemic risk unique to the banking sector cannot be excluded. The question then is whether the elements of discretion Chapter 15 provides the ordinary bankruptcy courts would suffice in essence to ring-fence local assets in mitigation of this situation.

Given that any systemic risk arising from uncovered interbank loans undoubtedly would amount to a multiple of locally available assets, the question of identifying the proper administrator of the local aspects of the insolvency would be largely irrelevant to that problem; that is, any administrator could only capture a minor component of the eventual harm in any event. In this connection it is also important to recall that the pre-insolvency intervention of the host-country sector regulator would be the far more important tool of damage control, a tool whose use would not necessarily be compromised by the possibility of a later squabble over the crumbs found on the local table. And in federal-state jurisdictional terms, it also is important to recall that for the large majority of foreign bank US branches and agencies – all but the mentioned grandfathered ones – the absence of federal deposit insurance brings with it the exclusive role of the state supervisor in the early correction (or eventual liquidation) of an insolvent unit. The federal agencies have no role to play in that eventuality.³⁹

b. The Governmental Claimant

Much more important, and key to the discussion, is the proposition that the Central Bank's (or Fed's) role as a provider of credit to all banks, including the local branches and agencies of foreign banks,⁴⁰ requires that these providers have first call on local assets to make good any losses they may have suffered from a credit extension. That indeed is a complex question; and a good starting point for its discussion lies in the Brief filed by the Federal Reserve Bank of New York as amicus curiae in the Deposit Agency litigation.⁴¹

³⁸ On this point the findings reported in *Terrell et al.*, supra n. 33, remain relevant even if the proportions of these funding sources and thus of these liabilities among themselves undoubtedly have changed over the past two decades.

³⁹ See the full discussion in Section 2.09 of *Gruson/Reisner*, supra n. 30,, at 87.

⁴⁰ The Federal Reserve Banks' discount windows are open to these entities, as is the so-called daylight overdraft coverage; see 12 U.S.C. Secs. 347(d) and 461 (b)(7).

⁴¹ On file with author.

The Brief's argument is as follows: Since (e.g.) the New York Federal Reserve Bank has made arrangements with many foreign banks to pledge eligible assets to the Bank in exchange for access to the essential daily overdraft privileges and occasional discount window credits,⁴² and since its respective loans are routinely secured by the registration of financing statements under Article 9 of the Uniform Commercial Code and analogous federal rules (for federal securities collateral), recourse to those assets must be had in New York and under the priority scheme of that Article. In part this proposition rests on Article 9 itself, which does not apply its general rule requiring filing in the home country of the debtor⁴³ to the case of filings involving foreign bank debtors.⁴⁴ In part it rests on the onerous burden of investigating, implementing, and trusting analogous perfection requirements in the branches' respective home countries if that alternative to New York filing and perfection procedures had to be undertaken. And in part it rests on the mentioned reluctance of US governmental units to litigate before a foreign forum and thereby run the risk of having waived foreign sovereign immunity against possible counterclaims and cross-complaints.

Two inquiries are relevant to any analysis of these propositions. The first is the factual inquiry into the volume, frequency, and other salient characteristics of these credit arrangements. Depending on the outcome of such an inquiry, it is possible that the jurisdictional competence question might be handled on an ad-hoc rather than on a generalized basis. The *Jugobank* case itself is a good example: Neither New York agency was a borrower from the Federal Reserve Bank in any of these categories, leading to the question of whether any other local (private sector) creditor in this specific liquidation proceeding should have the benefit of the ring-fencing of local assets the Bank's proposed resolution would bring with it.

The second inquiry is a more systemic one and divides into two subparts. The first derives from a traditional market analysis: What costs would be associated with a system that did not assure the Fed the automatic access to the collateral security it believes

The current Federal Reserve Board struggle to maintain the banking system's liquidity and credit-extension capacity in the teeth of the subprime mortgage market's collapse lends particular salience to these functions and highlights the importance of these tools in the systemic sense – that, however, is an issue beyond the scope of this discussion, as it relates more to monetary policy than to the role of the government as creditor in the event of an uncovered loan.

⁴² The Federal Reserve Act, 12 U.S.C. Sec. 343 and implementing regulations require that discount window lending be secured lending, collateralized by assets that can readily be liquidated, such as U.S. Treasury and other similar securities. The same rule applies to some extent to the overdraft facility, but not to the discount window collateral facility, which covers “daylight” overdrafts and thus permits use of the CHIPS-analogous Fedwire for dollar-denominated bank credits.

⁴³ UCC article 9-307(b).

⁴⁴ UCC article 9-307(f) specifies that the state of the principal US office is where the perfection of the security interest is to be filed.

necessary to the proper functioning of its credit-facilitation operations, and who would bear them?⁴⁵

The second subpart of the inquiry, however, is of a different sort. All concerned with the supervision of this sector agree that well-structured and continuous supervision, with its attributes of flexible, quick, and particularized intervention, is the essential feature of protection – that collapse, reorganization, and liquidation are, as they should be, the unusual and undesirable outcomes. If that is so, the essential question is whether, how, and to what extent that preventive framework would be compromised were those rare events subject to the more universalistic, less territorial approach to transnational bankruptcy now associated with the use of the standard bankruptcy regime, in contrast to the described territorial ring-fencing approach of the specialized regime. The direct backward linkage of the bankruptcy court regime to the effective functioning of the supervision regime is not established at present. To a degree, this stance of uncertainty relates back to the question of the availability of other mechanisms of insuring against the loss of access to local branch assets; it also relates to future developments in cross-border cooperation among home and host supervisory agencies, clearly a moving target today.

The *Deposit Insurance Agency* litigation, whatever its eventual outcome, can serve as a useful launching pad for the work needed to establish the appropriate mix of sector-specific and general regulatory oversight in these cross-border situations. The absence of any state or federal governmental claim against the two US agencies of the Yugoslav banks, coupled with the freeze and temporary retention of approximately \$100,000,000 in local assets, sharply highlights the need for careful examination of these jurisdictional conflicts. If more assets were retained in the host country than needed to satisfy local claims,⁴⁶ then the US administrator will function essentially as would the US bankruptcy court, turning over to the home administrator all assets not subject to ring-fencing.⁴⁷ On the whole, those should be the same assets a bankruptcy court, exercising its Chapter 15 discretion, would be expected to turn over.

In the most general sense, these scenarios suggest that the time may have come to consider whether the current law and practice of bank-insolvency situations is an anomalous remnant of an earlier time. At the generic (not sector-specific) level of transnational bankruptcy administration, the ever more explicit turn to cross-border

⁴⁵ Insuring this risk by means of a premium obligation placed on only the branches and agencies of foreign banks might conceivably be an approach, one internalizing the costs of the occasional breakdown within the appropriate universe of beneficiaries of the access to these facilities. That part of the inquiry would be well beyond the scope of this short presentation and of my competence, but is a common type of inquiry in analogous situations. Most likely, however, the contingencies of both the eventual risk and the universe of entities to be covered may make this an unlikely candidate for this approach.

⁴⁶ Putting aside the possibility, which the quoted provisions of the New York Banking Law are designed to prevent, that home- or third-country claimants somehow could convert their status to that of local claimants (e.g., perhaps by the non-recourse purchase of those claims by local parties). Proper administration of the proceedings, however, presumably would bar such maneuvers.

⁴⁷ As indeed is required by the quoted Banking Law provisions.

judicial cooperation is an interesting expression of an emerging general trend towards cross-border judicial discourse.⁴⁸ At the sectoral level, the cross-border cooperation between home and host country banking regulators embodied in that component of the Basle Concordats also suggests a trend away from at least the more aggressive aspects of national insistence on the procedural as well as the substantive aspects of ring-fencing. Whether those two trends in time will lead to the reconsideration of current law and practice of course is unpredictable.⁴⁹ But a somewhat more nuanced consideration of the balance of public and private, of local and global, of particular and systemic interests than that presently offered can only be welcomed.

⁴⁸ See the interesting if controversial study by Anne-Marie Slaughter, *A New World Order* (Princeton 2004).

⁴⁹ The recent decision of the U.S. Bankruptcy Court, *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 2007 WL 2479483 (S.D.N.Y. Aug. 30, 2007), involving a non-banking institution and leveraged financing, and comparing EU and U.S. treatment of “Center of Main Interest” definitions in order to open liquidation proceedings despite the incorporation of the Fund in the Cayman Islands is a bellwether in this regard.