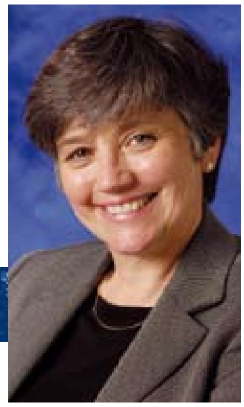
Model Law on Cross-border Insolvency

Exclusion of Australian Banks



FEATURE ARTICLE

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Introduction

The current volatility in the world's financial markets leads us to examine how the insolvency of Australian and foreign banks is treated in an international cross-border perspective. While Australia recently enacted the *Cross-Border Insolvency Act 2008* (Cth) (**CBIA**) by which the UNCITRAL Model Law on Cross-Border Insolvency (the **Model Law**) applies to cross-border insolvencies, banks and insurers are in fact excluded from the operation of the Model Law.[2] This article discusses the reasons for that and the impact of that exclusion, illustrated by some comparative case studies. International cross-border insolvency law necessarily has to be seen in the context of the domestic bank insolvency laws which are in the process of significant change. For the purposes of this article, we are only able to briefly explain those, although their impact is very significant in a wider context. We also acknowledge that the likelihood in Australia of a bank reaching the stage of formal insolvency is remote given the level of prudential requirements and the reality that a bank may well not be **allowed** to fail.

The Australian bank insolvency regime

Australia takes three significant approaches in relation to the insolvency of banks:

1 they are generally subject to a separate regulatory and insolvency regime under particular legislation, the *Banking Act 1959* (Cth) (the **Banking Act**);

2 that insolvency regime gives priority assistance to Australian depositors; and

3 as we have said, banks are excluded from the operation of the UNCITRAL Model Law.

Australia now adopts a fourth approach in light of the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008* (Cth) (the **FSLA Act**), that is, a government guarantee to pay out bank depositors to a certain level in the event of the bank's insolvency.

Separate insolvency regime under particular legislation

Australia's banking sector is largely subject to an insolvency regime separate to that applying to ordinary trading companies and is regulated under the Banking Act by the Australian Prudential Regulation Authority (**APRA**). The term *'authorised deposit taking institution'* (**ADI**) is used, being a corporate entity to which APRA has granted an authority to carry on banking business in Australia; and a foreign ADI refers to a foreign bank which has been so authorised.[3]

Under this regime, s 13A of the Banking Act allows APRA to investigate and take control of an ADI's business or appoint a *'statutory manager'* if APRA considers that the ADI is **likely** or **about** to fail. APRA may then apply, under s 14F, to wind up the company, which liquidation takes place under the *Corporations Act 2001* (Cth) (the **Corporations Act**). Needless to say perhaps, no such application has ever been made. Nevertheless the FSLA Act now revamps aspects of the insolvency regime under the Banking Act. In particular, s 13A is amended to allow APRA to intervene earlier, in circumstances where it merely considers that the ADI **may** fail. Also, recapitalisation provisions for an insolvent bank are to be available to a statutory manager as being a well recognised method internationally for dealing with a bank failure.

Priority assistance to Australian depositors

Another significant feature of Australia's banking laws is that in the case of the insolvency of an Australian ADI, s 13A(3) of the Banking Act provides that bank depositors in Australia have first claim to the assets in Australia of that ADI; s 11F(3) makes similar provision in relation to a foreign ADI. In support of these priorities, ADIs which take retail deposits in Australia are required to hold assets in Australia at least equal to their deposit liabilities in Australia.

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1. The authors acknowledge the helpful comments on earlier drafts of this article by Richard Fisher AM, University of Sydney, and Ian Walker, Minter Ellison
2. CBIA s 9; Cross-Border Insolvency Regulations 2008 (CBIR), reg 4.
3. See s 5 Banking Act.

Such *'ring-fencing'* of assets in favour of particular creditors is contrary to the *pari passu* principle that all claims of a similar type should be treated equally in an insolvency. In contrast, the purpose of ring-fencing in this context is to ensure that Australian creditors receive preferential treatment over foreign creditors.

The practice of ring-fencing is frequently criticised. The Model Law reflects an approach to cross-border insolvency under which an insolvent debtor's assets should be administered on a global basis for the interests of all creditors. Thus Article 13(1) provides that foreign creditors are generally to have the same rights as local creditors.

Nevertheless it is not an uncommon policy in relation to the protection of bank depositors. In that respect, despite Article 13(1), ring fencing can be supported by Article 6 which allows a State's court to refuse to act under the Model Law if the action would be *'manifestly contrary'* to the public policy of that State. The priority given under Australian law to Australian insurance policyholders was accepted by the House of Lords in *McGrath v Riddell*;[4] indeed the United Kingdom had adopted a similar position.

The Financial Claims Scheme

The new feature of our bank insolvency laws is the financial claims scheme (**FCS**) introduced by the FSLA Act which includes deposit protection for bank depositors.[5]

… the purpose of ring-fencing in this context is to ensure that Australian creditors receive preferential treatment over foreign creditors.

The FSLA Act establishes an Early Access Facility for Depositors, to be administered by APRA. Its purpose is to ensure that depositors in a failed ADI have immediate or early access to their deposit funds, which they would otherwise receive through the liquidation process under the depositor preference arrangements.

The Federal government proposes that depositors be guaranteed for a certain level of deposits, at least for the first three years of the scheme's operation. The scheme applies to both individual and business depositors.

Once a depositor is paid, APRA will then *'stand in the shoes'* of each of the depositors as a creditor in the winding up of the bank.

Again, government guarantees of local depositors are common internationally.

4. [2008] UKHL 21.
5. As at the time of writing; see Part II, Division 2AA Banking Act.
6. At [.14].
7. See Model Law Article 5.

Exclusion of banks from the Model Law

The final aspect of our laws is that an ADI cannot be the subject of proceedings brought under the CBIA. The relevance of the exclusion of ADIs from the Model Law will depend on the circumstances, for example whether there is a local or foreign insolvency involving the ADI, or both.

The stated reason for excluding ADIs from the operation of the Model Law appears in the Explanatory Memorandum to the Cross-Border Insolvency Bill 2008[6] which simply refers to the fact that special insolvency arrangements apply to banks, and insurers, and the application of the Model Law *'should not disturb'* these. The Memorandum goes on to say, on the one hand, that extension of the Model Law to these classes of entity may be raised for consideration at a later date; and on the other hand, that other classes of entity may emerge to which the Model Law should not apply.

The UNCITRAL Guide to the Enactment of the Model Law (the **Guide**) in fact contemplates this exclusion in enacting States. It acknowledges what are seen as the central roles that banks provide in a State's economic well being. The present global financial crisis is indicative of that. Nevertheless, the Guide also raises a number of matters that an enacting State might usefully consider. For example, the Guide suggests that the enacting State might want to treat, for recognition purposes, a foreign insolvency proceeding relating to a bank as an ordinary insolvency proceeding in a situation where the insolvency of the branch or of the assets of the foreign entity do not fall under the State's national regulatory scheme. That in fact applies, unless the local business operations of the foreign bank in fact qualify as an ADI, the CBIA does not exclude it from the Model Law.

As well, the Guide warns that States should be careful of inadvertently and undesirably limiting the right of the insolvency administrator or court to seek assistance or recognition overseas merely because that insolvency is subject to a special regulatory regime. In Australia, a liquidator of a local bank cannot seek assistance in another jurisdiction pursuant to the CBIA;[7] although as we explain later, the liquidator may be able to do so under the existing *'aid and assistance'* provisions in the Corporations Act.

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Also, even where there is exclusion of banks from the Model Law, the Guide asks States to consider whether they should allow certain features of the Model Law, for example, on cooperation and coordination and possibly on certain types of discretionary relief, to apply.

While the Model Law does not rely on reciprocity and so deals with cross-border insolvencies even where the foreign jurisdiction has not adopted the Model Law, its efficacy overseas is likely to be affected by whether the relevant foreign jurisdiction has adopted it or similar universalist principles. A relatively small number of countries have enacted the Model Law, and these do not include many of Australia's significant trading partners, in particular in Asia.[8] Perhaps more significantly, the Model Law contemplates the insolvency of a single corporate entity as opposed to a corporate group. In the banking sphere, that is a significant limitation, although corporate group issues can be addressed, in part, through the determination of the *'centre of main interests'*, a concept which we explain later.

Comparative cross-border insolvencies

We now examine some cross-border bank insolvency case studies in order to illustrate how Australia's regime applies.

Under that regime:

- an Australian bank depositor has priority over Australian assets in the insolvency of an ADI;
- that depositor also has government deposit protection;
- APRA becomes the creditor in the liquidation, and thereby assumes the priority position of the depositor;
- no assistance can be afforded to a foreign insolvency representative of a foreign bank under the CBIA against the assets of an ADI, whether a foreign ADI or local ADI;[9] however
- the foreign insolvency representative may have other recourse under the Corporations Act or general principles on recognition and enforcement of foreign judgments or orders.

Hypotheticals

Two simple hypothetical scenarios may assist with explaining the ramifications of this policy in the administration of a cross-border bank insolvency with operations in the United States and in Australia. Those two scenarios are that:

1 there is a proceeding under Chapter 11 of the US Bankruptcy Code[10] in respect of the US parent but the Australian entity is solvent – scenario 1;

2 there is both a US Chapter 11 proceeding in respect of the US parent and the Australian entity is also in insolvency – scenario 2.

We then compare the circumstances between:

- a bank and a normal trading company; and
- the respective situations of the foreign and local entities being separate legal entities; and where they are parts of a single legal entity. The significance of this arises in relation to the determination of the *'centre of main interests'* (**COMI**) of the Australian insolvent entity, which itself then determines whether relevant insolvency proceedings are *'foreign main proceedings'* under the Model Law. For example, with an insolvent US parent and a local Australian subsidiary, the question arises whether the relevant courts would find that Australia was the COMI for the subsidiary or whether its mode of operation within the corporate group is such that its COMI is in fact the United States. The latter case would mean that any US proceedings in respect of the subsidiary are the foreign main proceedings and the Australian insolvency proceedings are treated as concerning only an *'establishment'* of the subsidiary.

Banks and the Model Law

The comparative case studies below show Articles of the Model Law that would apply were banks in Australia not to be excluded from its operation; and even if that exclusion applies, how the structure by which a foreign bank operates in Australia is relevant.

8. UNCITRAL lists States that have adopted the Model Law. These include Japan, New Zealand, Poland, Republic of Korea, Romania, South Africa, the United Kingdom, and the United States of America: http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html (viewed 26 October 2008).
9. Note that APRA publishes a list of ADIs at http://www.apra.gov.au/ADI/ADIList.cfm (viewed 26 October 2008) including the foreign subsidiary banks and the branches of foreign banks.
10. Chapter 11 is a chapter of the United States Bankruptcy Code, which permits reorganisation under the US bankruptcy (that is, insolvency) laws. It contrasts with Chapter 7 which governs the process of a liquidation.

The indiscriminate application of the whole of the Model Law would perhaps be unwise given the complex interaction of insolvency and financial services laws, not to mention the wide range of other intersecting laws on companies, securities, financial instruments and so on.

An exclusion may also be seen as necessary in light of the Australian policy of priority given to local depositors and the government guarantee given to deposits; this is despite the apparent protection available under the public policy exception in Article 6.

However, the exclusion of banks also means that certain Articles of the Model Law are not available which would in fact provide beneficial assistance to Australian insolvency practitioners and courts in relation to local insolvency administrations of ADIs. In our view, consideration should be given to allowing those aspects of the Model Law to apply to banks.

A. Separate but related corporate entities
Trader Corp USA Ltd [*TCUS*], incorporated in the USA, and its subsidiary
Trader Corp Aust Ltd [*TCAL*], incorporated in Australia

Scenario 1 - no concurrent insolvency proceedings, that is, the US entity is in insolvency, the Australian entity is not	**Scenario 2 – concurrent insolvency proceedings, that is, both the US entity and the Australian entity are in insolvency**
■ TCUS enters Chapter 11 ■ TCAL continues to trade	■ TCUS enters Chapter 11 ■ TCAL is placed in Part 5.3A voluntary administration
TCUS may become engaged in proceedings in Australia – for example there may be garnishee proceedings brought against TCAL by a local creditor and TCUS becomes involved [11] – or TCUS may have assets in Australia, such as its interest in TCAL. In that case, the foreign US representative of TCUS could apply to, say, the Federal Court of Australia seeking recognition in Australia of the Chapter 11 proceedings as a *'foreign main proceeding'* and thus obtain an Article 20 automatic stay [12] or suspension of any action against TCUS or its assets (such as its interest in TCAL), and perhaps further relief under Article 21. TCUS may also seek the cooperation of the Federal Court in respect of the *'foreign proceeding'* (Articles 7, 25 and 27). In addition, the US representative of TCUS has access to the Australian courts to commence local insolvency proceedings (Article 11).	In this situation where both TCUS and TCAL are in insolvency in their respective countries, the Model Law may provide avenues for cooperation and coordination between the respective insolvency representatives and the courts. Although proceedings have been commenced against different debtors, concurrent proceedings in respect of each debtor in each jurisdiction may be advantageous and the Model Law may be useful to facilitate coordination of such a group insolvency. Foreign creditors of TCAL may participate in the Australian proceedings, under Article 13. If proceedings have for any reason been started in respect of TCAL in the US, then the Model Law provisions on concurrent administrations (and cooperation) would apply. If insolvency proceedings in respect of TCAL have been opened only in Australia, then the Model Law would be most relevant in respect of cooperation where events in the United States are pertinent to the administration of the Australian insolvency.

Separate but related banking corporations
What Bank USA [*WBUS*], incorporated in the USA as a bank, and its subsidiary is
What Bank Aust Ltd [*WBA*], the locally incorporated subsidiary to carry on banking business in Australia as an ADI

Scenario 1	**Scenario 2**
The Model Law would not apply. The foreign representative of WBUS would still have some, lesser, avenues to pursue. It could look to assistance from the Australian court under s 581(3) of the Corporations Act although the type of assistance would be discretionary. WBUS could also rely on the corporate group relationship and any practical control it may thereby exercise over WBA. WBUS would be confronted with the regulated environment under the Banking Act and the protections given to Australian depositors, including, under the FCS, APRA.[13]	In the circumstances, where WBA is in external administration in Australia, the Model Law would not apply to WBA. The WBA insolvency administrators would need to rely on the Corporations Act and general law principles should they need to obtain assistance in the US. Assuming WBUS is only connected with Australia due to its shareholding in WBA, its foreign representative would largely rely on the relationship between WBUS and WBA to frame its dealings with the insolvency representative of WBA.

11. For a pre-CBIA example of garnishee proceedings against a local subsidiary of a foreign company that is subject to foreign insolvency proceedings, see *ML UBase Holdings Co Ltd v Trigem Computer Inc* [2007] NSWSC 859.
12. Note that the scope of an Article 20 stay is subject to Australian insolvency law under which different principles apply in a voluntary administration to a liquidation.
13. Note the WBUS insolvency representative would be acting in a context in which the US has also excluded banks from the ambit of the Model Law: s 1501(c)(1) and s 109(b) US Bankruptcy Code.

B. Same corporate entities **Trader Corp USA Ltd [*TCUS*], incorporated in the USA** **Trader Corp Aust [*TCA*] is the business name only under which TCUS trades in Australia, operating as a registered foreign company under s 601CE of the Corporations Act rather than incorporating a subsidiary**	
Scenario 1	**Scenario 2**
■ TCUS enters Chapter 11 ■ TCA continues to operate	■ TCUS enters Chapter 11 ■ TCA is insolvent
In this case, the foreign representative of TCUS may seek the same sort of remedies under the Model Law as if TCA were a subsidiary, that is, recognition in Australia of the US proceedings over TCUS as a *'foreign main proceeding'* and an Article 20 automatic stay and further relief under Article 21. However without a separate entity (TCAL), dealing with TCUS assets would be simpler.	Creditors of TCUS are circling the company's assets and undertakings in Australia. The US directors have two alternatives to consider, the first whether to take advantage of the Model Law to obtain recognition in Australia of the Chapter 11 proceedings as a *'foreign main proceeding'* and obtain an Article 20 stay; the second whether to place TCUS (trading as TCA) in voluntary administration in Australia. If the latter occurs, the Model Law will also provide avenues for cooperation and coordination between the respective insolvency representatives and the courts, particularly useful for concurrent proceedings working towards a business rescue. If TCUS were placed in a Chapter 7 liquidation in the US (instead of a Chapter 11 proceeding) and so were placed in liquidation in Australia as a registered foreign company under s 601CL of the Corporations Act then the Model Law would supplement the proceedings to assist with court or representative cooperation between the concurrent proceedings (s 22(2) CBIA)).

Same banking entities **What Bank USA, incorporated in the USA** **It operates an Australian representative office that is not an ADI**
■ WBUS is in insolvency proceedings in the US with a view to a rescue; and ■ WBUS is operating in Australia through a representative office only.
WBUS is not an ADI and so the Model Law would apply. However, in practical terms there are likely to be few assets or liabilities in Australia because a representative office may not carry on banking business in Australia and must limit itself to *'the conduct of liaison and research activities'*.[14]

The relevant articles are:

- Article 5, which gives an Australian practitioner general authority to act in a foreign jurisdiction;
- Articles 25, 26, 27 – which deal with court and insolvency representative inter-communications;[15] and
- Articles 28, 29 and 30 – which deal with the circumstances of court co-ordination of concurrent insolvency proceedings.

For example, there are benefits in the Australian court or representative being able to seek assistance or recognition of the Australian insolvency proceedings in foreign States where there may be assets of the bank, or evidence to be taken. Given the range of approaches of foreign jurisdictions to cross-border insolvency cooperation and the diversity of foreign courts' willingness to recognise a foreign insolvency representative without some specific permission to do so, where a foreign jurisdiction has adopted the Model Law, then allowing Article 5 to apply to an Australian liquidator of a bank may be of threshold significance to their recognition and any subsequent cooperation.

14. APRA 2007, Guidelines on being Authorised as a Representative Office of a Foreign Bank, p 4. http://www.apra.gov.au/ADI/upload/Guidelines_ForiegnB_Mar07.pdf (viewed 17 October 2008)
15. See the Supreme Court of New South Wales recent Practice Note that parties should consider the Guidelines applicable to Court-to-Court Communication in Cross-border Cases, published by the American Law Institute and the International Insolvency Institute, in formulating a proposed framework for cooperation under Article 25: Clause 32, Practice Note SC Eq Div 4 (Corporations List): http://www.lawlink.nsw.gov.au/lawlink/supreme_court/ll_sc.nsf/pages/SCO_procedures (viewed 24 October 2008). Also see https://ali.org/doc/Guidelines.pdf (viewed 22 October 2008).

The application of Article 25, in so far as it provides that an Australian court *'shall'* cooperate with foreign courts and representatives, would serve to strengthen s 581 of the Corporations Act by imposing a mandatory obligation to co-operate.[16] Section 581 permits an Australian court to request the *'aid and assistance'* of foreign courts in cross-border insolvencies, and likewise to accede to their requests. In that respect, the introduction of the CBIA has not relevantly changed the existing law. For example, a s 581 order was recently made by the Supreme Court of New South Wales on application from the liquidators of HIH. As the Supreme Court said, a direct approach to the English court could have been made by the liquidators under the Model Law, seeking an order that the winding up of HIH was the *'foreign main proceeding'*, and thereby giving the English court direct jurisdiction to make orders for the obtaining of the information sought by the liquidators.[17]

Section 581 therefore remains available in relation to a bank insolvency. It was seen by the HIH liquidators as providing the more convenient process in that case, particularly given that the alternative process involved the preliminary step of obtaining an order of recognition.[18] However in more complex foreign inquiries, the CBIA process may be simpler and more effective. In addition, its provisions have been adopted by particular foreign jurisdictions where the aid and assistance provisions and related jurisprudence do not exist.

As to the remaining Articles of the Model Law, they focus on the rights of foreign insolvency representatives and creditors to take action in Australia for their own purposes. That is where the real concerns exist about opening up Australian banks to such actions, in particular in light of our regime of protection of local creditors and government guarantee of depositors. Nevertheless, the point should be made that such actions may themselves also serve the purposes of Australian creditors. For example, if a foreign insolvency representative secures a stay against execution by a creditor against a local debtor company, or prevents it disposing of its assets, that may serve the interests of all creditors, including those in Australia. Indeed the reasons given in the Explanatory Memorandum for the adoption of the Model Law in Australia take a global perspective on the need to avoid existing uncertainties and risks and costs to businesses generally in matters of international trade. The Memorandum says that it:

> ... would be of overall benefit to businesses in all countries to have adequate mechanisms in place to deal efficiently and effectively with cross-border insolvencies. Reforms of this nature will facilitate international trade in goods and services and the integration of national financial systems with the international financial system.

Similarly, the NSW Chief Justice has recently emphasised the adoption of the Model Law as part of the progressive removal of barriers to international trade.[19]

Australian companies and creditors are having to face the fact that the commercial world is increasingly globalised and that in the circumstances of any insolvency they may be required to stand alongside foreign creditors and be subject to foreign liquidations. In effect they become international creditors in an international insolvency administration.

A broader perspective

In this consideration of the Model Law, it must be acknowledged that the insolvency of banks is dealt with in a broader context than any regime under the Banking Act or the Corporations Act. Their financial position is strictly prudentially regulated, where the term *'solvency'* has a quite different meaning than that which applies to trading companies. The wider reality is that governments do not generally let banks fail, certainly in Australia and other advanced economies. What governments require of banks in difficulty is that they be reorganised so as to ensure the continuing viability of their operations. Recapitalisations and takeovers have been recently common overseas. In that context the issue is not so much whether the Model Law, or the Banking Act, should apply but rather whether legislative and regulatory mechanisms are in place to facilitate such reorganisations of a financially troubled bank which operates trans-nationally including in Australia.

While that is so, there is nevertheless a legislative insolvency regime which is in place, and which has strengthened by the FSLA Act. However remote the application of that regime may be, it may remain incomplete and without proper support in the case of a cross-border bank insolvency. Any departure from the increasingly globalised approach in the regime providing for such an insolvency has to be carefully assessed. This is so, first to ensure that there are sufficiently good policy and legal bases for the exclusion of banks from the Model Law; and second, to ensure that the exclusion does not in fact hamper the administration of a bank insolvency when or if one were to arise.

16. Section 22(1) CBIA.
17. Article 21(1)(d) Model Law.
18. *McGrath & Anor as Liquidators of HIH Insurance Ltd* [2008] NSWSC 881 at [15] – [16].
19. Spigelman CJ, "Cross-border Insolvency: Cooperation or Conflict?", Paper presented at INSOL International Annual Regional Conference, Shanghai, 16 September 2008.