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Bank Insolvency Regimes in the United States and the United Kingdom

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I. INTRODUCTION

Bank insolvency regimes vary widely. First, many countries maintain separate bank insolvency rules from those that govern insolvency of other firms or individuals. Other countries have no special regime and rely on their general insolvency law for bank closure. Second, some countries rely on an administrative process for bank closure in which the bank supervisor, bank insurer, or other agency has the power to appoint the conservator or receiver, and, in some instances, may appoint itself to the job. Other countries rely on a judicial process in which the bank supervisor (or bank managers or creditors) must apply to the court for the appointment of a conservator or receiver.

A comparison of the United States and United Kingdom bank insolvency regimes reflects many of the different approaches used throughout the world. The U.K. system relies on general insolvency law for the closure of banks. The system is judicial in that a court decides whether a bank is insolvent and insolvency is the only basis for closing the bank. In contrast, the U.S. system for bank closure is administrative and derives from banking law. Bank supervisors determine insolvency, and under some circumstances may close even a solvent bank.

The differences between the two approaches are fundamental and stem from the underlying purpose and function of general insolvency law, as opposed to the system of bank supervision. While the fair treatment and protection of the insolvent firm's creditors grounds insolvency law, banking supervision grows out of systemic concerns, and its fundamental aim is not the protection of individual creditors. An International Monetary Fund ("IMF") report summarizes the dilemma:

> An extrajudicial regulatory process offers greater efficiency than a court-administered process; this is an important advantage if immediate action to close or transfer the business of a bank is required for systemic reasons. However, granting the regulator the power to act expeditiously and to avoid delays inherent in court administration has a significant cost: excluding the courts tends to deprive bank creditors and other interested parties of the procedural and substantive safeguards that they enjoy under a proper court-administered proceeding. This argument carries even greater weight in bank insolvencies where the deposit insurance agency is appointed receiver, as the agency will usually suffer a conflict between its interests as one of the largest creditors of the bank and its role as impartial receiver.[1]

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1. Tobias M.C. Asser, IMF, LEGAL ASPECTS OF REGULATORY TREATMENT OF BANKS IN DISTRESS, 10-

II. STRUCTURE OF INSOLVENCY REGIMES IN THE UNITED STATES AND THE UNITED KINGDOM

All forms of prudential bank regulation, of course, are ultimately tied to preventing insolvency. Such regulation is generally justified on the basis of the systemic implications of bank failure. The discussion below focuses on regulatory intervention in cases where the bank is already insolvent (although some of the regulatory powers discussed may be triggered prior to insolvency). Other types of regulatory intervention such as open bank financial support or regulatory enforcement actions often precede such cases. One option discussed below is the appointment of an administrator or conservator. This course of action is appropriate in situations in which drastic measures are appropriate, but where there remains hope for the ongoing survival of the institution. The administration order or conservatorship draws a close parallel to the U.S. Chapter 11 bankruptcy. The other option is the receivership. The institution of the receivership proceedings is for the ultimate purpose of closing the bank. The receivership can be compared with the U.S. Chapter 7 bankruptcy, in which liquidating assets is the goal, although the way in which the closure is achieved can vary considerably.

A. *Administration Orders and Conservatorships*

Generally, the purpose of the administration order (sometimes called provisional administration) or a conservatorship is to: (1) rehabilitate incompetent management and operations so that the bank can survive as an ongoing concern; or (2) preserve all or part of the bank's assets so that the bank may be sold or merged with another institution. The advantages of the administration order are not always available. A recent IMF study observed:

> In several countries the law does not provide for regulatory provisional administration. One practical reason may be that the bank regulator simply lacks the staff resources to manage a bank or to supervise the management of a bank by an administrator. This argument is more serious than it may seem at first glance. Bank regulators are not in the business of managing and operating banks but of exercising prudential banking supervision. Prudential banking supervision is not the same as bank management, and bank regulators do not necessarily have the qualifications, experience, or even the temperament required of a successful bank manager. Provisional administration lends itself to abuse. For instance, provisional administration has been used to postpone the inevitable closure of banks, owing to political pressure or because the

11 (2001), *at* http://www.imf.org/external/pulas/nft/2001/lart/ (last visited Feb. 20, 2005) (copy on file with *The Transnational Lawyer*).

deposit insurance system lacked the funds to pay off depositors. Obviously, the use of provisional administration to mask forbearance is likely to worsen the condition of the banks concerned and to increase the costs associated with their resolution that will be borne by the state and by their creditors.

Finally, yet not less important, in most countries with provisional administration for banks, bank owners largely retain their rights. As a result, they could frustrate a provisional administration. Therefore, the appointment of a receiver whose powers exceed those of the provisional administrator and typically include those of the bank's owners is often preferred.[2]

The U.K. Financial Services Authority ("FSA") lacks the authority to take control of a troubled bank. Rather, the FSA, the bank or its directors, or the firm's creditors may apply to the court for the appointment of an administrator. The court may make an administration order if the court "is satisfied that a company is or is likely to become unable to pay its debts."[3] The inability to pay debts is determined under two tests: (1) the balance sheet test: "where it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities;" and (2) the cash flow or liquidity test: "if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due."[4] With regard to banks, this requirement is satisfied if the bank is in default on a payment obligation.[5] Other grounds for the appointment of an administrator include the court's determination that the appointment would realize the survival of the company as an ongoing concern or a more advantageous realization of the company's assets.[6]

The court-appointed administrator has broad powers and "may do all such things as may be necessary for the management of the affairs, business and property of the company."[7] These powers include the ability to remove officers and directors and appoint new ones, but do not include the power to act on behalf of shareholders.

The FSA considers many factors in determining whether to seek an administration order or, as discussed below, a compulsory winding up order. In general, in seeking an insolvency order, the FSA will consider the needs of the

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2. *Id.* at 122.

3. Insolvency Act, 1986, c. 45 pt. II § 8(1)(a) (Eng.), *available at* www.insolvencyhelpline.co.uk/insolvency-act/ia1986.htm (last visited Feb. 20, 2005) [hereinafter "Insolvency Act 1986].

4. *Id.* § 123.

5. Financial Services and Markets Act 2000, § 359(3) and (4), *at* http://www.hmso.gov.uk/acts/acts2000/00008-ai.htm#359 (last visited Feb. 20, 2005) (copy on file with *The Transnational Lawyer*).

6. Insolvency Act 1986, *supra* note 3, § 8(3).

7. *Id.* § 14(a).

consumers and its regulatory objectives.[8] More specifically, the FSA will consider, among other things, whether the bank or any creditor or consumer is taking steps to deal with the bank's insolvency; whether the FSA's actions will result in better consumer protection; the nature and extent of the bank's assets and liabilities; whether there will be significant cross border effects to an insolvency order; and whether there is a risk of certain creditors being preferred.[9]

In sharp contrast to the U.K. system, U.S. bank supervisors may appoint the Federal Deposit Insurance Corporation ("FDIC") as conservator. The FDIC may appoint itself as conservator based on the statutory standards for appointment and to prevent a loss to the deposit insurance fund.[10] As in the United Kingdom, the statutory grounds for appointment of a conservator include the balance sheet and liquidity insolvency tests. In addition, however, the statutory grounds also include: substantial dissipation of assets or earnings (due to a violation of law or any unsafe or unsound practice); an unsafe or unsound condition; willful violation of an administrative cease and desist order; concealment of the bank's records from the bank supervisor; losses that have or will likely deplete all or substantially all of the banks capital; undercapitalization; and guilt of certain money laundering offenses.[11] While judicial review is available for the appointment of a conservator or receiver, courts give substantial deference to the administrative determination overturning the decision only if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law."[12]

The powers of the FDIC as conservator are extensive. As conservator, the FDIC may take any action: "(i) necessary to put the insured depository institution in a sound and solvent condition; and (ii) appropriate to carry on the business of the institution and preserve and conserve the assets and property of the institution."[13] Notably, the FDIC has the power to prescribe regulations regarding the conduct of its own conservatorships or receiverships and can prescribe rules that allow the FDIC to exercise any function normally held by a shareholder, officer or director of the institution.[14] Moreover, the FDIC, as conservator or receiver, has statutory authority to merge a bank with another bank.

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8. FSA HANDBOOK, CHAPTER 10: INSOLVENCY PROCEEDINGS AND ORDERS AGAINST DEBT AVOIDANCE, 10.6.5, Release 034, Sept. 2004, *at* http://www.fsa.gov.uk/handbook/BL3ENFpp/ENF/chapter _10.pdf (last visited Feb. 20, 2005) (copy on file with *The Transnational Lawyer*).

9. *Id.*

10. 12 U.S.C. § 1821(c)(10).

11. *Id.* § 1821(c)(5).

12. *See* Franklin Sav. Ass'n v. Office of Thrift Supervision, 934 F. 2d 1127, 1142 (10th Cir. 1991).

13. 12 U.S.C. § 1821(d)(2)(D).

14. *Id.* § 1821(d)(1), (2)(C).

B. Receivership and Winding-Up

In England and Wales,[15] a bank's creditors may apply to the court for the appointment of a receiver for the purpose of winding up under the same standards that apply to the appointment of an administrator.[16] If the receiver applies to the court for directions with regard to the performance of any of the functions of the receiver, the FSA has the right to be heard upon such application.[17] The FSA may petition the court for an order directing the receiver to file reports or give notices or pay payments to a liquidator.[18] Finally, the receiver must notify the FSA if the company is engaging in regulated activities without authorization.[19]

In the United Kingdom, the FSA may petition the court for a compulsory winding up order (i.e., liquidation) and the court may wind up the bank if it is unable to pay its debts (according to the same definition as used in the appointment of an administrator) or if the court determines that it is just and equitable to do so.[20] The FSA may also participate in the voluntary winding-up of a bank.[21]

In the United States, the procedure and grounds for the appointment of a receiver are generally the same as for the appointment of a conservator. When the receiver is appointed for the purpose of liquidation or winding up, the receiver must be the FDIC.[22] The powers of the receiver are the same as that of a conservator, except that the receiver also has the power to place the bank into liquidation "having due regard to the conditions of credit in the locality."[23]

The U.S. special insolvency regime for banks imposes unique rules with regard to the distribution of the banks assets and liabilities. While secured creditors maintain their priority to the extent of their security, depositors receive priority over other unsecured creditors.[24] The FDIC has the authority to impose liability for losses of a failed bank on other commonly controlled banks (e.g., within the same bank holding company).[25] In addition, the FDIC has broad authority to repudiate contracts of an insolvent bank that were executed prior to conservatorship or receivership, if the contracts are burdensome and repudiation

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15. *See* Insolvency Act 1986, *supra* note 3, § 32 (stating the Act has separate rules for receiverships in Scotland).

16. *Id.*

17. FSMA 2000, *supra* note 5, § 363(2), *available at* http://www.hmso.gov.uk/acts/ acts2000/20000 008.htm (last visited Feb. 20, 2005) (copy on file with *The Transnational Lawyer*).

18. *Id.* § 363(3).

19. *Id.* § 364.

20. *Id.* § 367.

21. *Id.* § 365.

22. 12 U.S.C. § 1821(c)(2)(A)(ii).

23. *Id.* § 1821(d)(1)(E).

24. *Id.* § 1821(d)(11)(A).

25. *Id.* § 1815(e).

will promote the orderly administration of the bank's affairs.[26] The damages owed by the FDIC in the case of a repudiation are limited to "actual direct compensatory damages,"[27] which excludes punitive or exemplary damages, damages for lost profits or opportunity, and damages for pain and suffering.[28] During the 1990s, the FDIC used its repudiation power to avoid payment under employment severance agreements, arguing that the losses under such agreements were not actual direct compensatory damages. The courts' review of the FDIC position in such cases was mixed.[29] Finally, the FDIC also enjoys immunity from certain claims and defenses regarding the assets of a failed bank under a doctrine originating from a U.S. Supreme Court decision, *D'Oench, Duhme & Co. v. Fed. Deposit Ins. Co.*[30] The *D'Oench, Duhme* doctrine and its statutory correlary[31] have been the source of much scrutiny by courts and commentators.[32]

C. *Regulatory Forbearance*

Despite any formal or informal authority on the part of bank regulators to take significant and early action to address bank failure, powerful incentives push regulators to do nothing. Almost all of the constituents involved have reasons to avoid or delay the bank closure. Bank shareholders wish to avoid a fire sale of the bank's assets. Depositors, even if fully insured, wish to avoid dirupting their banking services. Bank directors and employees wish to retain their jobs. Bank supervisors and insurers seek to avoid costly payouts to depositors, the costs of liquidation, and the public exposure of regulatory failure. Lawmakers want to avoid any bad news on their watch, and a bank failure is headline bad news. Even general creditors and uninsured depositors may prefer methods other than closure to protect their interests. For example, such creditors may hope that the insolvent bank is purchased by a healthy one or that it receives some public assistance to avoid insolvency. Thus, the incentives all point away from bank closure. Yet, history has shown that early closure of insolvent institutions is often the least costly method of resolution.

A significant contrast between the U.S. and U.K. systems for bank insolvency is that the U.S. system has adopted formal rules to prevent forbearance, and the United Kingdom has no such formal rules. In the United States, Congress recognized that regulatory forbearance was a contributor to the

26. *Id.*. § 1821(e).

27. *Id.* § 1821(e)(3)(A)(i).

28. *Id.* § 1821(e)(3)(B).

29. Heidi Mandanis Schooner, *Refocusing Regulatory Limitations on Banks' Compensation Practices*, 37 B.C. L. REV. 861 (1996).

30. D'Oench, Duhme & Co. v. Fed. Deposit Ins. Corp., 315 U.S. 447 (1942).

31. 12 U.S.C. § 1823(e).

32. *See* PATRICIA A. MCCOY, BANKING LAW MANUAL § 16.04 (2002) (discussing the D'Oench Duhme doctrine comprehensively).

length and extent of the 1980s savings and loan crisis. Thus, in 1991, Congress created a system of formalized rules preventing regulatory forbearance. Prompt corrective action rules require bank regulators to place critically undercapitalized institutions in conservatorship or receivership within ninety days, unless the supervisor and the FDIC determine that other action would better serve the purposes of the statute.[33] Such determination may only be made if the bank: (1) has a positive net worth; (2) is in substantial compliance with an approved capital restoration plan; (3) is profitable or has an upward trend in earnings; and (4) has reduced its ratio of nonperforming loans to total loans. Moreover, the exception to mandatory conservatorship or receivership only applies if the head of the appropriate banking agency and the chairman of the bank's board certify that the institution is viable and not expected to fail.[34] Critically undercapitalized banks are subject also to certain mandatory operating constraints such as prohibitions on paying excessive compensation or bonuses.[35] Prompt corrective action rules also impose significant requirements (although not mandatory closure) on banks that are deemed either significantly undercapitalized or undercapitalized. For example, any undercapitalized institution must submit an acceptable capital restoration plan.[36]

III. UNDERSTANDING DIVERGENT REGIMES

Despite globalization and the expectation of, or hope for, convergence of regulatory systems, national regimes remain distinct. In the case of the U.S. and U.K. bank insolvency regimes, some of the reasons for divergence are quite clear and enduring.

The extensiveness of deposit insurance is unique in the United States. No other country comes close to the $100,000 in insurance coverage provided by the FDIC. The FDIC administers deposit insurance funds that must be maintained at not less than 1.25 percent of the total estimated insured deposits. As of 2003, the Bank Insurance Fund balance stood at more than $34 billion and the Savings Association Insurance Fund balance at more than $12 billion.[37] Overall, the FDIC insures well over $3 trillion in deposits.[38] The size of insured deposits make the FDIC the largest potential stakeholder in a banking crisis. This stakeholder status may justify the FDIC's extensive involvement in bank insolvencies. Moreover, the protection of the deposit insurance funds justifies the super receivership powers granted to the FDIC.

33. 12 U.S.C. § 1831(h)(3).

34. *Id.* § 1831(h)(3)(c)(ii).

35. *Id.* § 1831(i).

36. *Id.* § 1831(e)(2).

37. FDIC ANNUAL REPORT 2003, at 43, 63, *available at* http://www.fdic.gov/about/strategic/report/2003annualreport/ (last visited Feb. 20, 2005) (copy on file with *The Transnational Lawyer*).

38. *Id.* at 23.

Prior to 1982, the United Kingdom had no formal system for deposit insurance.[39] Today, the United Kingdom's deposit insurance scheme reflects the strong influence of the EU ("European Union") Deposit Guarantee Directive. The U.K. Financial Services Compensation Scheme offers deposit insurance, but the FSCS has no role in bank insolvency. Deposits are insured 100 percent for the first £2,000 and then for 90 percent of the next £33,000. The levy on banks for deposit coverage may not exceed 0.3 percent of covered deposits.

The nature of the bank industries in the United States versus the United Kingdom must also have an impact on the bank insolvency regime. The U.S. banking industry is populated by many banks (although dominated by a few), and the industry experienced widespread failures twice in the last century. The U.K. banking industry is limited to a handful of banks, and bank failures have been rare. Both countries can be accused (or applauded, depending on one's perspective) for employing "too big to fail" policies, but in the United Kingdom almost any bank is too big to fail. In the United Kingdom, therefore, there is a greater incentive to avoid the insolvency regime entirely and, instead, use informal and formal regulatory power to resolve troubled institutions without resort to the insolvency regime. In the United States, it is perhaps more inevitable that, each year, some banks will fail. In 2003, the FDIC resolved three bank failures. That year, the United States had 9,182 insured depository institutions. In an industry structure like that in the United Kingdom, it is perhaps less important to establish a special insolvency regime that provides extraordinary power to bank supervisors. Bank failures do not occur often, therefore, there is no urgency for a special regime. U.S. regulators resort routinely to special insolvency rules.

Finally, the overall differences in the respective countries' approach to bank regulation are reflected in the insolvency regimes.[40] Historically, the United States has maintained a formal system of controls over the banking industry. Bank activities have been constrained and highly regulated, and the system of regulation is formalized through statutes and regulations. In the United Kingdom, the history of bank regulation reflects a more informal system and only light control on activities. With regard to insolvency, the U.S. system reflects a highly specialized and thoroughly formal system (e.g., prompt corrective action rules) that grants extraordinary authority and discretion to bank regulators. In the United Kingdom, there is no special bank insolvency regime, and the FSA has much less formal control over the process. This means that the FSA's real power is likely to be informal and subject to far less legislative control.

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39. *See* ANDREW CAMPBELL & PETER CARTWRIGHT, BANKS IN CRISIS 177-94 (2002) (discussing deposit insurance in the United Kingdom and the United States). In contrast, New York established a deposit insurance system in 1828. *Id.*

40. *See generally* Heidi Mandanis Schooner & Michael Taylor, *Convergence and Competition: The Case of Bank Regulation in Britain and the United States*, 20 MICH. J. INT'L L. 595 (1999).

IV. THE IMPORTANCE OF NATIONAL REGIMES IN CROSS-BORDER INSOLVENCIES

The failure of the Bank of Credit and Commerce ("BCCI") serves as the icon for the challenges involved in cross-border insolvencies. BCCI, based in Luxembourg, operated in more than seventy countries, and national differences took their toll on the resolution of the insolvency. For example, Luxembourg liquidators attempted to consolidate all of BCCI's assets into a single pool for distribution to creditors worldwide. This approach was opposed by New York and California state banking supervisors who ultimately prevailed in maintaining control over BCCI assets in those states. This "ring-fence" approach led to inequality in treatment of BCCI creditors. Ring-fencing appears provincial. It does, however, serve to protect creditors of foreign branches; and those creditors might otherwise be disfavored by the home country supervisor. Moreover, it protects foreign branch creditors from the results of lax regulation by the home country supervisor.[41]

Quite contrary to the U.S. approach, the EU Directive on the Reorganisation and Winding Up of Credit Institutions ("the Directive")[42] is formulated on the single-entity, home country rule principles. Under the Directive, with regard to banks within the European Union, insolvency matters will be governed under the law of the bank's home Member State.[43] This means that the same set of insolvency rules will apply to all branches in host countries within the EU and, therefore, all creditors will be treated equally, i.e., in accordance with the same set of rules. In cases in which the insolvency bank has its head office outside of the EU and has branches in at least two member states, the Directive provides that the member states "shall endeavour to coordinate their actions" with regard to resolution.[44] The Directive was brought into force in the United Kingdom by the Credit Institutions (Reorganisations and Winding up) Regulations 2004.

Of course, the resolution of BCCI would have looked quite different had the Directive been in force at the time. Within the EU, Luxembourg would have been the home Member State and would have conducted the resolution. Significantly, the approach in the EU has not been one that sought (quite understandably) to dictate many changes in the substantive insolvency law in the member states. Rather, the home country rule principle accommodates national differences while providing a unifying principle. In this way, the Directive serves as a testament to the enduring nature of national insolvency regimes.

41. *See* RAJ K. BHALA, FOREIGN BANK REGULATION AFTER BCCI 301-302 (1994).

42. Council Directive 2001/24/EC of the European Parliament and of the Council of 4th April 2001 on the Reorganisation and Winding-Up of Credit Institutions, 2001 O.J. (L 125/15), *available at* http://secretariat.eftc.int/Web/EuropeanEconomicArea/EEAAgreement/annexes/annex9.pdf (noting member states were required to comply with the Directive by May 5, 2004).

43. Home Member State is defined at Article 1, point (6) of Directive 2000/12/EC.

44. Directive 2001/24/EC, *supra* note 42, art. 8.

V. CONCLUSION

The divergent bank insolvency regimes in the United States and United Kingdom reflect the more general approaches to bank regulation in those countries. Each approach has its advantages and disadvantages. The U.S. systems gives bank supervisors the power to act swiftly and decisively with regard to troubled banks and gives supervisors tremendous flexibility with regard to forms of resolution. On the other hand, the U.S. regime grants tremendous regulatory authority at the expense of bank creditors' rights. The U.K. system is quite equitable in its treatment of creditors and avoids supervisory overreaching through its reliance on a judicial process. On the other hand, the judicial process might fail to afford maximum speed and flexibility in a crisis.

The importance of national differences is plain in the case of cross border insolvencies. While the adoption of international standards for cross border insolvencies may be abstractly ideal, general convergence on bank regulatory issues has been slow, indeed, with the main success in capital regulation. The home country approach adopted in the EU addresses problems of coordination without requiring major substantive changes to any member states' insolvency law. Whether the home country principle will extend beyond the EU is both hard to imagine and hard not to.