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## Bank Resolution and Creditor Distribution: The Tension Shaping Global Banking –part II: The Cross-border Dimension

David Ramos  
*Carlos III University, Madrid*

Javier Solana  
*University of Glasgow*

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# Bank resolution and creditor distribution: the tension shaping global banking –Part II: The cross-border dimension<sup>1</sup>

David Ramos<sup>2</sup>

Javier Solana<sup>3</sup>

*New bank resolution frameworks that aim to address the complex task of managing the collapse of a large financial institution stand in considerable tension with basic principles and policy objectives of insolvency law. In this two-part study, we present an analytical framework that aims at helping us understand how this tension can undermine the effectiveness of the new bank resolution frameworks. In the first part of this article, we introduced our three-layered framework and explored its first two layers: the group dimension, and the duality of crisis-prevention and crisis-management tools. In this Part II, we explore the last layer: the cross-border dimension. As in Part I, we reflect on the practical challenges that resolution authorities are likely to face when implementing the new resolution frameworks. In addition, we use the insights from our analysis to reflect on the impact that these new bank resolution frameworks will have on the governance of international financial markets*

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<sup>2</sup> Senior Lecturer in Commercial Law, Carlos III University of Madrid; ; University of Bologna, Member of the Academic Board - European Banking Institute (EBI); Alternate Member of the Appeal Panel – Single Resolution Board (SRB).

<sup>3</sup> Lecturer in Commercial Law, University of Glasgow.

*and conclude that these frameworks will fundamentally change how large banks do business at the global level.*

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## I. INTRODUCTION

In the first part of this two-part article, we described how the new bank resolution frameworks that regulators in various jurisdictions developed to address the complex task of managing the collapse of large financial institutions stand in considerable tension with basic principles and policy objectives of insolvency law. We also presented an analytical framework that unpacks bank resolution into three layers of growing complexity: the group dimension, the duality of crisis-prevention and crisis-management tools, and the cross-border dimension. In Part I, we

examined the first two layers. In Part II, we resume the analysis and explore the third and final layer: the cross-border dimension.

In Section II, we describe the policies and principles underpinning cross-border insolvency and resolution. We also discuss the frameworks of cross-border insolvency and resolution, and the issues of applicable law, mutual recognition and cooperation. We then develop a critical analysis of cross-border resolution frameworks, focusing on the possibility of using principles underlying cross-border insolvency frameworks as a reference, and illustrating how it is mired in uncertainty, particularly as a result of unresolved frictions between principles and policies.

In Section III, we provide a more practical analysis of how cross-border resolution rules apply to the four operational liabilities that we identified in the first part as the object of our study: deposits, client money and client assets, liabilities arising from derivatives, and subordinated debt.

In Section IV we bring together the three layers in our analytical framework. We first examine the risks of applying crisis management tools to bank groups with cross-border operations. In particular, we analyse how the different treatment of a bank group's critical functions across the different jurisdictions in which it operates can thwart the coordination of resolution action at the global level. We then examine how the responses that regulatory authorities have given to these difficulties in crisis-management have resulted in the crisis-prevention tools that try to "balkanize" bank groups by disincentivising global business operations. In Section V, we argue that this is likely to turn bank groups into large, local ad intervened liquidity islands.

## II. THE GENERAL FRAMEWORK OF CROSS-BORDER INSOLVENCY AND RESOLUTION

The cross-border dimension continues to reflect the inner conflicts between insolvency and bank resolution discussed in the first part of this paper. First, we offer a brief explanation of how the tensions at the level of policy and principle mutate when we move to the context of *cross-border* insolvency and resolution (A). Secondly, we examine how, in the EU's regional framework, cross-border resolution builds upon cross-border insolvency, which gives rise to a robust system (B). Then we consider the (non) applicability of the cross-border insolvency system to cross-border resolution at the global level, and how this leaves a flawed patchwork of halfway solutions that endangers the whole system (C).

A. *Cross-border Insolvency and Resolution: Policies and Principles*

Cross-border insolvency has long been characterized by the debate between universalist and territorialist views. Universalists claim that a single procedure should apply to each entity, with a single law that is recognized across borders, in the name of efficiency (transaction cost-wise) and fairness (with a single legal background to be used as a baseline to assess each party's relative position).<sup>4</sup> Territorialist views would retort that, by vesting powers in a foreign authority, the universalist vision does not guarantee the interest of creditors located in a different jurisdiction, which is something that the authorities of that latter jurisdiction are bound to protect.<sup>5</sup> In our analysis of the possible frictions between bank resolution and insolvency law, an evident question arises: how does the system cope when, on top of cross-border insolvency law and its universalism-territorialism compromise, one adds bank resolution, with its different menu of policies?

The two aspects in which bank resolution is more likely to alter the picture are summarized by the words "contagion" and "group". At first glance, the objective of avoiding contagion could make the case for territorialistic, i.e. balkanized, solutions to limit cross-border spill-over effects and protect against two important concerns: home country authorities' disregard of creditors in other countries and home taxpayers' refusal to bail-out foreign creditors if the source of distress is perceived to be outside the home jurisdiction.<sup>6</sup> Yet such attitudes fail to grasp the complexity of multinational banking groups.<sup>7</sup> For example, if critical functions are situated in a specific jurisdiction, a territorialist approach would impair those critical functions, wreaking havoc across the whole

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<sup>4</sup> Jay L. Westbrook "A Global Solution to Multinational Default" *Michigan Law Review* Vol. 98 (2000) p. 2277.

<sup>5</sup> Thus, recent experiences like the Fortis bank, or Icelandic banks were to some extent characterized by territorialist approaches. Jonathan M. Edwards "A Model Law Framework for The Resolution of G-SIFIs" *Capital Markets Law Journal* Vol. 7 (2012) pp. 131-133.

<sup>6</sup> See, e.g. Rosa Lastra (ed.) *Cross-Border Bank Insolvency* Oxford University Press, 2011, p. 166.

<sup>7</sup> James M. Peck "Cross-Border Observations Derived from my Lehman Judicial Experience" *Butterworths Journal of International Banking and Financial Law* Vol. 30 (2015) p. 132.

bank entity or group, without improving the prospects of creditors in that jurisdiction.<sup>8</sup> The problem is an intricate one due to the conflict between the interests of national authorities, and it is aggravated by asymmetries of resources, accounting, legal and institutional infrastructures, and resolution regimes.<sup>9</sup> Early theoretical analyses made the point that ignoring cross-border externalities leads to globally inefficient outcomes, e.g. under-provision of recapitalizations.<sup>10</sup> Since then, the debate has shifted away from bail-outs and towards bail-in, but the basic tensions remain the same. Using the concept of “trilemma” for open economies,<sup>11</sup> Schoenmaker argued that, between financial stability, financial integration and national financial policies, it is only possible to pick two out of the three.<sup>12</sup> This has been used in the field of bank crises to justify a two-way choice in a three-way trilemma between global financial

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<sup>8</sup> Creditors would be comparably better off only if liquid assets were “located” in that jurisdiction, but that does not need to be coincident with the jurisdiction where critical functions are located. For example, imagine that the treasury functions are located in one jurisdiction, which means that the specific branch or entity is the one organizing liquidity management or hedging operations across the group, but that, in order to do so, it relies on collateral assets deposited with entities in other jurisdictions. It could also happen that the group treats the collateral as being deposited with the treasury branch/entity, but that in practice this entity relies on long, cross-border custody chains, where the treasury entity’s “ownership” of the collateral only derives from an electronic entry in the books of other custodian entities or central securities depositories in other jurisdictions. Ultimately, using a purely territorialist approach, if resolution were declared in each of these jurisdictions, the authorities of the country where each central securities depository is located could freeze the assets there and claim jurisdiction over them.

<sup>9</sup> *Ibid* p. 30. The authors argue that obstacles may be overcome primarily in cases where the failure of a bank and its branches or subsidiaries has systemic impact in both home and host countries, and even then it is far from sure.

<sup>10</sup> X. Freixas “Crisis Management in Europe” In J. Gremers, D. Schoenmaker; P. Wierds (eds.) *Financial Supervision in Europe* Cheltenham: Edward Elgar (2003) pp. 102–19.

<sup>11</sup> Obstfeld and Taylor proposed the original “open economy”, where a country that considers capital mobility, fixed exchange rates and monetary autonomy cannot have all three and must necessarily pick only two of them. See Maurice Obstfeld; Alan Taylor “The Great Depression as a Watershed: International Capital Mobility over the Long Run,” in Michael Bordo; Claudia D. Goldin; Eugene N. White, (eds.) *The Defining Moment: The Great Depression and the American Economy in the Twentieth Century* University of Chicago Press (1998), pp. 353–402. Dani Rodrik described his own “augmented trilemma” between “integrated national economies”, “nation state” and “mass politics”. See “How Far Will International Economic Integration Go?” *Journal of Economic Perspectives* Vol. 14 No. 1 (2000) pp. 177–186.

<sup>12</sup> Dirk Schoenmaker “The financial trilemma” *Economic Letters* 111 (2011) pp. 57–59.

stability, cross-border banks, and national authorities:<sup>13</sup> countries can only foster global financial stability and global banks by handing over part of their sovereignty.<sup>14</sup>

Sovereignty is rarely relinquished in full. Thus, the ideal solution would be a pre-commitment to mutual recognition and coordination. This could take the form of (i) a centralized system with central powers and authorities, such as the one inside the Eurozone; or a fully harmonized system, as in the EU, which tries to accomplish single-jurisdiction status;<sup>15</sup> (ii) a system of common rules, such as an international convention on cross-border bank resolution,<sup>16</sup> or an international model law;<sup>17</sup> and, in its absence, (iii) a combination of reliance on cross-border bank *insolvency* principles, unilateral recognition of resolution action and contractual solutions (see section II.C below).

### B. *Regional Approaches (EU and Eurozone): When Cross-border Resolution Builds Upon Cross-border Insolvency*

The EU offers the single existing example of a regionally integrated area with different countries that try to appear as a “single jurisdiction” for purposes of bank resolution rules.<sup>18</sup> To minimize the risk of divergence, however, the outcome of applying common bank resolution rules must not be altered by the applicable insolvency law, which differs from country to country. The first step to enhance certainty and predictability is to ascertain what is the law applicable to “normal insolvency proceedings” on ranking and priorities, the formula used by bank resolution rules.<sup>19</sup> This is the law of the “home Member State”

<sup>13</sup> Stijn Claessens; Richard J. Herring; Dirk Shoenmaker; Kimberly A. Summe “A Safer World Financial System: Improving the Resolution of Systemic Institutions” *Geneva Reports on the World Economy* 12 (2010) p. 32.

<sup>14</sup> *Ibid* p. 33.

<sup>15</sup> See section II.B below.

<sup>16</sup> Institute of International Finance (IIF), Making Resolution Robust – Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Institutions (June 2012).

<sup>17</sup> See Mattias Lehmann “Bail-In and Private International Law: How to Make Bank Resolution Measures Effective across Borders” *International and Comparative Law Quarterly* Vol. 66 (Jan. 2017) pp. 107-142; or Irit Mevorach “Beyond the Search for Certainty: Addressing the Cross-Border Resolution Gap” *Brooklyn Journal of Corp. Fin. & Com. L.* Vol. 10 (2015) pp. 183-223.

<sup>18</sup> EBA Final Report on MREL EBA-Op-2016-21| 14 December 2016, PP. 16, 49.

<sup>19</sup> See Article 44 BRRD. The relevant texts to determine the law applicable to insolvency proceedings in the EU are the Directive 2001/24/EC on the reorganisation and winding up of credit institutions (the Winding-Up Directive), and Regulation 878/2015 on

under cross-border bank insolvency rules,<sup>20</sup> a more predictable factor than the more uncertain “centre of main interest” (“COMI”) that is used in general cross-border insolvency rules.<sup>21</sup> The “home Member State” will determine the law applicable to supervision, resolution and insolvency of the relevant institution.

Furthermore, general cross-border insolvency rules in the EU are universalist in nature and recognize “main” insolvency proceedings, but they also recognise ‘secondary insolvency proceedings’ in the place of a company’s establishment.<sup>22</sup> Bank cross-border insolvency rules are even more universalist and do not recognize secondary insolvency proceedings.<sup>23</sup> There are exceptions for rights *in re* over assets located in a State different from the home State,<sup>24</sup> and set-off and close-out netting rights subject to different contract laws.<sup>25</sup> These exceptions are not very relevant for our purposes because these rights are typically protected from harm in bank resolution cases, but they could have a significant impact in other cases.<sup>26</sup>

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International Insolvency Proceedings (the International Insolvency Regulation). Some authors have used this to propose different mechanisms for recapitalising banks. See, e.g. Charles Goodhart; Dirk Shoenmaker “Fiscal Burden Sharing in Cross-Border Banking Crises” *International Journal of Central Banking* Vol. 5 No. 1 (2009) pp.141-165.

<sup>20</sup> See Article 10 (2) of the Winding-Up Directive. According to article 2 of the Winding-Up Directive, the reference to “home Member State” shall be interpreted in accordance with article 4 (1) (43) of Regulation 575/2013 (Capital Requirements Regulation, or CRR), which refers to the Member State in which ‘an institution has been granted authorisation’.

<sup>21</sup> See Articles 3 (1) and 7 (1) of the Insolvency Regulation. Article 7 (2) (i) of the International Insolvency Regulation stipulates that the law of the COMI determines ranking and priorities. Despite the more vague definition there is a presumption in favour of the place of the registered office (see article 3(1) para. 2nd). The presumption was strengthened by the Court of Justice of the European Union in the case C-341/04 *Eurofood* [2006] ECR I-3854, where the Court seemed to imply that, in order to destroy the presumption in favor of the registered office, it would be necessary to demonstrate that the Company is a “letterbox Company” (*ibid* at 35), which is the test for cases of abuse of law. See case C-196/04 *Cadbury Schweppes* [2006] ECR I-8031 para. 68 (a tax case where the Court made reference to the “letterbox company”, and the *Eurofood* case as the test that should be met to prove abuse of law).

<sup>22</sup> See Article 3 (2) EU Insolvency Regulation; article 2 (c) and (f) UNCITRAL Model Law on Cross-Border Insolvency.

<sup>23</sup> See e.g. recital (16) Winding Up Directive.

<sup>24</sup> See Articles 21, 24 Winding Up Directive.

<sup>25</sup> Articles 23 and 25 Winding Up Directive.

<sup>26</sup> Mattias Lehmann “Bail-In and Private International Law: How to Make Bank Resolution Measures Effective across Borders” *cit.* pp. 117-119.



More problematic is the fact that creditors located in States other than the home State have the right to lodge claims and to “be treated in the same way and accorded the same ranking as claims of an equivalent nature which may be lodged by creditors having their domiciles, normal places of residence, or head offices in the home Member State.”<sup>27</sup> Since “ranking” is a matter for the *lex concursus*,<sup>28</sup> should “equivalence” be solely determined by the *lex concursus* as well, or limited in any way by the law under which the claims were originated?<sup>29</sup> This should not obscure the fact that using a single insolvency law for private rights is an intrusion, and some legal systems are reluctant to allow a law other than the *lex contractus* to govern variations in the contract,<sup>30</sup> which creates obstacles to accept the applicability of such law if the procedure is not characterized as “insolvency” or equivalent, e.g. restructuring procedures.<sup>31</sup>

The second step to enhance certainty and predictability is to ensure an automatic recognition of decisions across different jurisdictions. The Winding-Up Directive grants decisions the same effect in other EU countries that they have in the home Member State.<sup>32</sup> The CJEU has reinforced the idea of automatic recognition against different objections.

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<sup>27</sup> Article 16 Winding Up Directive. (Emphasis added.)

<sup>28</sup> Article 10 (2) (h) of the Bank Winding Up Directive.

<sup>29</sup> Recital (15) of the Directive seems to support an exclusive determination by the *lex concursus*, by stating that: “The exemption concerning the effects of reorganisation measures and winding-up proceedings on certain contracts and rights is limited to those effects and does not cover other questions concerning reorganisation measures and winding-up proceedings such as the lodging, verification, admission and ranking of claims concerning those contracts and rights and the rules governing the distribution of the proceeds of the realisation of the assets, which are governed by the law of the home Member State.” However, if the classification of a specific claim is a matter of public policy in the country where the claim is originated, it is difficult to conclude that the *lex concursus* would be unchecked.

<sup>30</sup> Simon Gleeson “Chapter 5. The Consequences of Chapter 14 for International Recognition of US Bank Resolution Action” in Thomas H Jackson; Kenneth Scott; John Taylor Making Failure Feasible: How Bankruptcy Reform Can End Too Big to Fail Hoover Institution, Stanford University Press, 2015, p. 113.

<sup>31</sup> Ibid with reference to *National Bank of Greece and Athens SA v. Metliss* [1958] AC 509 (House of Lords); *Adams v. National Bank of Greece* [1961] AC 255 (House of Lords); *Global Distressed Alpha Fund 1 v. P. T. Bakrie*, 2011] EWHC 256 (Commercial court).

<sup>32</sup> See Article 3 (1) and (2) and 9 (1) para. 2<sup>nd</sup> of the Winding-Up Directive. The forerunner is the system of the Brussels Convention, now Brussels Regulation 44/2001 on Recognition and Enforcement of Judgments on Civil and Commercial Matters (now recast as Regulation 1215/2012), which laid the ground for the Insolvency Regulation and the Winding-Up Directive.

For example, in case C-85/12 *LBI*, two attachment orders against an Icelandic bank succeeded despite the fact that the measures were based on legislative provisions rather than acts of administrative or judicial authorities.<sup>33</sup> The EFTA Court for the European Economic Area (EEA) also upheld the principle of automatic recognition in E-28/13 *LBI hf v Merrill Lynch International Ltd*,<sup>34</sup> relying on *LBI* to hold that all states must recognize that the home state and its law determine the validity or voidability of detrimental acts, and that this must be subject only to narrowly construed exceptions, which did not apply in a case where Icelandic law determined the avoidance of bond payments despite the agency agreement, the bonds and their payment coupons being subject to English law.<sup>35</sup>

BRRD rules superimpose themselves upon this scheme, and the measures subject to mutual recognition under the Winding Up Directive

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<sup>33</sup> Case C-85/12 *LBI hf v Kepler Capital Markets SA and Frédéric Giroux*, 24 October 2013. The Icelandic measures, consisting in a prohibition of legal actions against entities benefitting from a moratorium, were considered effective in France. The combination of legislative measures (including retroactive amendments) conditional upon judicial or administrative action were considered subject to automatic mutual recognition, as there had been such judicial measures. Regarding the fact that the legislative measures themselves were not subject to challenge, the Court held that: ‘In the context of the system established by Directive 2001/24, the reorganisation and winding-up measures of the home Member State are, as is apparent from the second subparagraph of Article 3(2) and the second subparagraph of Article 9(1) of that directive, recognised “without any further formalities”. In particular, that directive does not make the recognition of reorganisation and winding-up measures subject to a condition that it be possible to bring an action against them. Similarly, according to the second subparagraph of Article 3(2), the host Member State may likewise not make that recognition subject to a condition of that type for which its national rules may provide.’ Case C-85/12 *LBI hf v Kepler Capital Markets SA and Frédéric Giroux*, 24 October 2013 at 40. The attachment orders were considered “enforcement actions” and thus subject to the home Member State jurisdiction rather than “lawsuits pending” subject to the law of the State where the lawsuit is pending. *Ibid* paras. 51-58, with reference to article 32 of the Winding Up Directive.

<sup>34</sup> E-28/13 *LBI hf v Merrill Lynch International Ltd*, 17 October 2014.

<sup>35</sup> *Ibid* at 73. The contention was over article 30 (1) of the Winding Up Directive, which provides that: ‘Article 10 shall not apply as regards the rules relating to the validity, voidability or unenforceability of legal acts detrimental to the creditors as a whole, where the beneficiary of these acts provides proof that: — the act detrimental to the creditors as a whole is subject to the law of a Member State other than the home Member State, and — that law does not allow any means of challenging that act in the case in point.’ The defendant would have needed to prove the non-voidability of the acts pursuant to the English laws that would be applicable in the case (including insolvency law, contract law, statutes of limitation, etc).

now include resolution measures.<sup>36</sup> If anything, the mutual recognition principle has been reinforced, since BRRD articles 63 *et seq.* of BRRD directly regulate the powers of resolution authorities and the applicable safeguards instead of relying on national law. Article 66 of the BRRD, which regulates the power to enforce crisis management measures or crisis prevention measures by other Member States, provides a broad principle of effectiveness and recognition for transfers of shares and instruments of ownership, assets, rights or liabilities in States other than the state of the resolution authority where these may be located,<sup>37</sup> together with a duty to provide the resolution authority with the necessary assistance for effecting such transfers.<sup>38</sup> For bail-in measures adopted by the resolution authority, article 66 of the BRRD provides the recognition in the State whose law governs the instruments and in the State where the creditors are located.<sup>39</sup> While effectiveness in the State whose law governs the instruments is logical, the reference to the State of location of creditors is problematic if a creditor is located in a Member State but the liabilities are governed by a third country's laws because any interference would hardly be justified, even on public policy grounds.<sup>40</sup> Finally, article 66 of the BRRD subjects the safeguards applicable to transfers or bail-in measures, and the rights of shareholders, creditors or third parties to challenge them, to the laws of the resolution authority's State and excludes any right to challenge under the laws of their own jurisdictions.<sup>41</sup>

Despite the clear intention of the EU legislature, court pronouncements show that the devil is often in the details. The first of those is the *Goldman Sachs v. Novo Banco* case,<sup>42</sup> where Banco de Portugal ("BdP"), as resolution authority for Banco Espírito Santo ("BES"), a major Portuguese bank, made a series of decisions to transfer *some* of BES' assets and liabilities to a bridge bank, Novo Banco ("NB"), leaving others behind. In a first decision (the "August decision"), BdP indicated the types of liabilities that would be transferred, which included a loan facility subscribed by BES with Oak

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<sup>36</sup> See new no. (4) of article 1, and article 2 of the Winding-Up Directive, introduced by article 117 of BRRD. See also recital (119) of BRRD.

<sup>37</sup> Article 66 (1) BRRD.

<sup>38</sup> Article 66 (2) BRRD.

<sup>39</sup> Article 66 (4) BRRD.

<sup>40</sup> Mattias Lehmann "Bail-In and Private International Law: How to Make Bank Resolution Measures Effective across Borders" *cit.* p. 125.

<sup>41</sup> Article 66 (3) (5) and (6) BRRD.

<sup>42</sup> *Goldman Sachs v Novo Banco*, [2015] EWHC 2371 (Comm).

Finance Luxembourg (“Oak”). Later, however, BdP stated in another decision (the “December decision”) that the loan facility subscribed by BES with Oak would not be transferred to the bridge bank.

The loan facility was expressly subject to English law and to the jurisdiction of English courts. Thus, Goldman Sachs, as assignee of Oak’s claim under the loan facility, sought repayment of the loan from NB arguing that English courts had jurisdiction to determine whether NB was a party to the loan facility entered into by BES as its predecessor, despite NB not being a signatory. Goldman Sachs further argued that the December decision was equivocal because, while it purported to “transfer”, it merely declared a “no transfer”, which, Goldman Sachs argued, was not within the express powers granted to BdP under the BRRD.

The commercial court found for Goldman Sachs, holding that the BES’ liability under the loan facility had been transferred to NB and that the latter was therefore bound by the English jurisdiction clause. The judge based its decision on the Brussels I Regulation, which is conceived for civil disputes outside times of crisis, holding that the case was a contractual matter. Only then did the court turn to the BRRD. The court adopted a narrow formal interpretation of the term “transfer” under article 66 of the BRRD and found that the December decision fell outside its scope.<sup>43</sup>

This narrow interpretation was overturned by the Court of Appeal, which held that the December decision was a “reorganisation measure” in the sense of the Bank Winding-Up Directive and thus fell within the scope of mutual recognition.<sup>44</sup> Thus, the December decision had to be given effect by the English courts and NB was “not a party” to the loan facility extended to BES at the time of the August decision.<sup>45</sup> This decision was recently upheld by the UK Supreme Court in even more rotund terms.<sup>46</sup>

Another EU precedent concerned the resolution of Heta, a specific entity created in 2014 by an *ad hoc* act to manage the crisis of the Hypo

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<sup>43</sup> See *Goldman Sachs v Novo Banco*, [2015] EWHC 2371 (Comm) at 94.

<sup>44</sup> See [2016] EWCA Civ 1092, 4 November 2016, paras 24-34. The UK Court of Appeals relied on the broader interpretation of “reorganisation measures” under art 2 of Directive 2001/24 laid out in the decision of the Court of Justice of the European Union of *Kotnik and Others v Državni zbor Republike Slovenije* (Case C-526/14).

<sup>45</sup> See [2016] EWCA Civ 1092, paras 36-39.

<sup>46</sup> See [2018] UKSC 34, paras 27, 28.

Alpe Adria group.<sup>47</sup> The *ad hoc* act provided for the annulment of certain financial obligations. Once the BRRD was transposed into Austrian law, the Austrian legislature passed another act to resolve Heta despite it not being a credit institution. Also, as a mechanism to protect taxpayers, the act cancelled or introduced a 15-month moratorium in the debt instrument issued by Hypo Alpe and Heta as a pre-condition for the valuation of the entity and the application of resolution tools, including the identification of “bail-in-able” liabilities.

Some of the debt had been acquired by the public bank Bayern LB, which challenged the Austrian decision before the Munich court. The court refused to grant cross-border recognition<sup>48</sup> because, firstly, these were not “reorganisation” or “recapitalisation” measures but “liquidation” measures, and they did not concern a bank but another institution;<sup>49</sup> and, secondly, the administrative act adopting the measures merely transposed a *legislative* act, which was not among the acts subject to recognition. Having rejected the application of BRRD or the Winding Up Directive, the court also refused to grant the measure the status of a public policy measure under article 9(3) of Rome I Regulation, since its purpose was not to protect financial stability, but rather Austrian public finances, and to the detriment of German creditors.<sup>50</sup>

These are puzzling arguments. The view that a court can subject recognition to a sort of “pedigree” test, where it examines the purposes for which the measures are used, seems at odds with the automatic recognition system that lies at the core of the BRRD and the Bank Winding Up Directive.<sup>51</sup> The objection based on the legislative nature of the act seems to have been explicitly rejected by the CJEU in *LBI*.<sup>52</sup>

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<sup>47</sup> Heta’s purpose was to wind down Hypo Alpe’s assets. See Mattias Lehmann “Bail-In and Private International Law: How to Make Bank Resolution Measures Effective across Borders” *cit.* p. 133.

<sup>48</sup> BayernLB v Hypo Alpe Adria (HETA case) Regional Court, Munich I, judgment of 8 May 2015, BeckRS 2015, 15096. Available at: [http://www.gesetze-bayern.de/\(X\(1\)S\(fngr2brnlkwonln4pai0cuz3\)\)/Content/Document/Y-300-Z-BECKRS-B-2015-N-15096?hl=true&AspxAutoDetectCookieSupport=1](http://www.gesetze-bayern.de/(X(1)S(fngr2brnlkwonln4pai0cuz3))/Content/Document/Y-300-Z-BECKRS-B-2015-N-15096?hl=true&AspxAutoDetectCookieSupport=1)

<sup>49</sup> *Ibid.*

<sup>50</sup> Bayern LB v Hypo Alpe Adria (HETA case) Regional Court, Munich I, judgment of 8 May 2015, BeckRS 2015, 15096.

<sup>51</sup> Aside from covering ‘winding up’ proceedings, pursuant to article 9 (1) of the Directive these encompass ‘winding up proceedings concerning a credit institution’, which could cover Heta proceedings, because they concerned Hypo Alpe, i.e. a bank.

<sup>52</sup> Case C-85/12 *LBI hf v Kepler Capital Markets SA and Frédéric Giroux*, 24 October 2013.

Then, protecting public funds is a (public policy) goal of the BRRD.<sup>53</sup> Unfortunately, since the specific act was annulled by the Austrian Constitutional Court on grounds that it unfairly discriminated between creditors,<sup>54</sup> a sensible ground that was not at the core of the German decision, there was no appeal and the German decision became final.

The *Novo Banco* and *Hypo Alpe Adria* decisions exemplify the importance of some of the basic ideas discussed here. In both cases, courts clung to open-textured concepts to narrow-down the rules' scope of application: for example, a decision to "transfer" in the commercial court ruling in *Novo Banco*, or the applicability of the rules to "credit institutions" and to administrative measures by a "resolution authority" in the *Hypo Alpe Adria* case. While the mere textual readings were excessively formalistic and hard to justify, beneath them lay a concern over the fair treatment of creditors, which in itself is justified as reflective of public policy. Creditor treatment matters for bank resolution, but it is placed in a broader framework where more macro interests, such as contagion or market discipline, are a driving force.<sup>55</sup> In this context, courts may perceive that not only do the "micro" goals yield to the "macro" ones, but also basic principles that establish rights such as "equal treatment" are being trumped. Even if such a conclusion is wrong, it does not aid the cause of mutual recognition that the decision is perceived as illegitimate,<sup>56</sup> which happens when the process is characterized by a lack of transparency and justification, and a degree of improvisation and inconsistency, as shown by BdP's amendment/clarification of its transfer decision or the Austrian authorities' discriminatory treatment of creditors.

It is therefore not correct to criticize the court rulings without also criticizing the decisions they reviewed and, we admit, it is unfair to lay the blame at the doorstep of public authorities which were learning by doing. Yet in both cases, the courts refused to enforce decisions despite the applicable legal framework, indicating a clear intent to (i) supersede the normal framework of contracts and civil disputes, and (ii) foster a system of automatic recognition. Indeed, within EU bank resolution

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<sup>53</sup> Article 31 includes among "resolution objectives" the need "(b) to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline"; and (c) to protect public funds by minimising reliance on extraordinary public financial support".

<sup>54</sup> See Mattias Lehmann "Bail-In and Private International Law: How to Make Bank Resolution Measures Effective across Borders" *cit.* p. 133.

<sup>55</sup> See Part I, section II.B.

<sup>56</sup> See Part I, section II.C.

rules, cross-border provisions may be the ones that try to address the tensions of policy and principle in a clearer manner. If one wishes to identify the main source of uncertainty in this context, it is not in the rules themselves or in their intent, but in the tensions at the level of policy and principle in non-cross-border provisions and in the absence of legitimate processes to resolve them in each specific case.

*C. International Approaches: When Cross-border Resolution does not Build upon Cross-border Insolvency*

A legal framework for cross-border cooperation is a key attribute of effective resolution systems.<sup>57</sup> Such framework should include rules that encourage cooperation and information exchange, a prohibition to automatically trigger domestic resolution action as a result of foreign proceedings, a prohibition of discriminatory treatment of foreign creditors, rules that give effect to resolution decisions of foreign authorities through mutual recognition or the unilateral exercise of powers under domestic law, and the power to deal with local branches of foreign banks.<sup>58</sup> The state of current rules is far from this benchmark: there are insufficient rules to ease cooperation and recognition, and creditors are not treated equally.<sup>59</sup> This made it necessary to develop frameworks of recommendations for statutory and contract solutions to enhance cross-border recognition.<sup>60</sup>

Yet cross-border insolvency provides a promising precedent, which could have been used as a basis to then develop the specialties for bank resolution. The UNCITRAL Model Law on Cross-Border Insolvency provides an international standard for domestic laws,<sup>61</sup> based on a “modified universalist” model:<sup>62</sup> the debtor’s Centre-of-Main-Interest

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<sup>57</sup> FSB Key Attributes of Effective Resolution Regimes for Financial Institutions October 2011 (updated 2014) Key Attribute (KA) no. 7.

<sup>58</sup> KA 7, nos. 7.1, 7.2, 7.3, 7.5.

<sup>59</sup> FSB *Thematic Review on Resolution Regimes. Peer Review Report* 11 April 2013, pp. 29-31, Annex D, Table 6.

<sup>60</sup> FSB *Cross-border recognition of resolution action* Consultative document, 29 September 2014.

<sup>61</sup> It is the blueprint for the laws of countries such as the United Kingdom, Poland, Romania, Canada, Australia, New Zealand, Korea, or Chapter 15 of the US Bankruptcy Code, to name some. See the status of the UNCITRAL Model Law in [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html)

<sup>62</sup> See, e.g. Jason Fincke ‘Coordinating Cross-Border Bankruptcy: How Territoriality saves Universalism’ *Columbia Journal of European Law* Vol. 15 (2008) p. 43. For a classification of models, see Donald T. Trautman; Jay Lawrence Westbrook; Emmanuel

(COMI) determines the place of the “main proceedings,” the jurisdiction of the courts, and applicable laws,<sup>63</sup> with concessions for rights *in rem* and “territorial proceedings.”<sup>64</sup> Cross-filing of claims is possible, and foreign creditors must not be treated worse than local ones.<sup>65</sup> Courts have used these rules to recognise foreign insolvency proceedings, relied on foreign precedents to interpret Model Law concepts,<sup>66</sup> engaged with the substance of the facts to determine the COMI even in cases involving jurisdictions well-known as a base for shell companies,<sup>67</sup> and refused recognition in light of facts, rather than prejudice or discrimination.<sup>68</sup>

Thus, if the UNCITRAL framework is successful, why can it not be used as the basis for cross-border resolution action? *Should* it be used for that purpose? It is evenly balanced and provides open-textured concepts susceptible of interpretation together with key principles such as non-discrimination. It has proven useful to deal with typical bank creditors, such as bondholders<sup>69</sup> or “financial” debtors, such as financial advisors,<sup>70</sup> financial companies,<sup>71</sup> funds,<sup>72</sup> insurance companies<sup>73</sup> or even banks.<sup>74</sup>

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Gaillard ‘Four Models of International Bankruptcy’ *American Journal of Comparative Law* Vol. 41 (1993) p. 573.

<sup>63</sup> Article 17 (1) (recognition) and 17 (2) (a) (recognition as main proceeding) in relation with article 2 (b) of the UNCITRAL Model Law

<sup>64</sup> If the entity has an ‘establishment’. Article 17 (1), 17 (2) (b) (recognition) in relation with article 2 (c) (foreign ‘non-main proceedings’) and 2 (f) (definition of ‘establishment’) UNCITRAL Model Law.

<sup>65</sup> Articles 9 *et seq.* UNCITRAL Model Law.

<sup>66</sup> For example, US courts have used the CJEU *Eurofood* case in numerous occasions. See, for example, *In re Schefenacker* No. 07-11482 (Bankr. SDNY June 14, 2007),

<sup>67</sup> For example, *In re Amerindo Internet Growth Fund Ltd* (Bankr. SDNY Feb. 9 2007); *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 46 (Bankr. S.D.N.Y. 2008); *In re Am. Pegasus, SPC*, Case No. 11-34429 (Bankr. S.D.N.Y. Dec. 23, 2011); *Ackers v Saad Investments Company Limited* (in official liquidation) [2010] FCA 1221 (Cayman Islands), *In re Tri-Continental Exchange Ltd* 349 B.R. 627 (Bankr. C Dist. Cal. 2006) (St. Vincent and the Grenadines), or *In re: Gerova Financial Group, Ltd.*, 482 B.R. 86 (Bankr. S.D.N.Y. 2012); *Re Millennium Global Emerging Credit Master Fund Limited*, No. 11 Civ. 7865 (LBS) (SDNY 25 June 2012) (Bermuda), or *In re Spencer Partners Ltd* No. 07-02356-JC (Bankr. South Carolina, 29 May 2007) (Isle of Man).

<sup>68</sup> See, e.g. *In re SphinX Ltd* 351 B.R. 103 (Bankr. SDNY, 2006); *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd* 374 B.R. 122 (Bankr. SDNY 2007).

<sup>69</sup> *In re Schefenacker* No. 07-11482 (Bankr. SDNY June 14, 2007).

<sup>70</sup> See, e.g. *In re Ian Gregory Thow*, No. 05-30432 (Bankr. W.Dist. Wash Seattle, 2005).

<sup>71</sup> *Ackers v Saad Investments Company Limited* (in official liquidation) [2010] FCA 1221; *In re: Gerova Financial Group, Ltd.*, 482 B.R. 86 (Bankr. S.D.N.Y. 2012).

<sup>72</sup> *In re SphinX Ltd* 351 B.R. 103 (Bankr. SDNY, 2006); *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd* 374 B.R. 122 (Bankr. SDNY 2007); *In re*



There are two main objections to the UNCITRAL framework. One, cross-border insolvency rules *cannot* be used when they are excluded.<sup>75</sup> Two, they *should not* be used because resolution *authorities*, and not courts, are preponderant, and resolution policies and principles differ from those of insolvency.

Regarding the first objection, some laws *expressly* exclude banks and financial companies from insolvency, both domestic and cross-border, like the US.<sup>76</sup> Some authors say that the case is the same in the UK, due to the separate treatment of resolution and insolvency.<sup>77</sup> Yet the question is whether the presence of a bank should automatically exclude the application of the UNCITRAL framework. If one looks at the UNCITRAL Model Law guide to enactment, the answer seems to be “no”: the guide states that the exclusion of banks should not rule out the

Amerindo Internet Growth Fund Ltd (Bankr. SDNY Feb. 9 2007); Re Millennium Global Emerging Credit Master Fund Limited, No. 11 Civ. 7865 (LBS) (SDNY 25 June 2012).

<sup>73</sup> HIH Casualty and General Insurance Ltd, [2008] UKHL 21; In re Tri-Continental Exchange Ltd 349 B.R. 627 (Bankr. C Dist. Cal. 2006); Re European Insurance Agency AS (unreported court order) No. 6-BS30434, 8 August 2006.

<sup>74</sup> In re *The International Banking Corporation* B.S.C. 439 B.R. 614 (SDNY 2012); Re JSC BTA Bank No. 10-10638 (JMP) (Bankr. SDNY 23 August 2010).

<sup>75</sup> Article 1 (2) of the UNCITRAL Model Law on Cross-Border Insolvency states that: ‘This Law does not apply to a proceeding concerning [designate any types of entities, such as banks or insurance companies, that are subject to a special insolvency regime in this State and that this State wishes to exclude from this Law].’ Section 109 (b) (2) and (3) of the US Bankruptcy Code excludes Banks and foreign Banks from the consideration as “debtors” for purposes of bankruptcy law.

<sup>76</sup> See Section § 1501 (c) (1), with reference to Section § 109 (b) of the US Bankruptcy Code. Section 109 (b) (3) (B) also excludes foreign banks with branches or agencies in the United States. See Paul Lee “Cross-Border Resolution of Banking Groups: International Initiatives and US Perspectives: Part III” *Pratt’s Journal of Bankruptcy Law* (2014) p. 295. Section II of the Dodd Frank Act, which regulates the Orderly Liquidation Authority, is even more explicit, when it states that ‘The provisions of this title shall exclusively apply to and govern all matters relating to covered financial companies for which the Corporation is appointed as receiver, and no provisions of the Bankruptcy Code or the rules issued thereunder shall apply in such cases, except as expressly provided in this title.’

<sup>77</sup> Simon Gleeson “The Consequences of Chapter 14 for International Recognition of US Bank Resolution Action” in Thomas H Jackson; Kenneth Scott; John Taylor Making Failure Feasible: How Bankruptcy Reform Can End Too Big to Fail Hoover Institution, Stanford University Press, 2015, p. 118. The chapter analyses a hypothetical Chapter 14 of the US Bankruptcy Code, but the argument permits extrapolation to the existing law: UK courts would have to determine, for purposes of recognition, whether foreign (US) resolution proceedings are “insolvency” proceedings, drawing an equivalence with UK law, where the powers are conferred part 1 of the Banking Act 2009 (resolution), and not part 2 (bank insolvency).

rules in cases where the assets or branches are not subject to a regulatory scheme that justifies a different treatment,<sup>78</sup> nor limit the right of a court or insolvency representative in a foreign bank to seek assistance using Model Law provisions.<sup>79</sup>

This logic was put into action in *In re Irish Bank Resolution Corporation Ltd.*<sup>80</sup> Irish Bank Resolution Corporation (IBRC) was a bridge bank institution that succeeded two Irish private banks (Anglo Irish Bank Corporation and Irish Nationwide Building Society) after they suffered severe liquidity crises and were nationalized by the State. It was considered necessary to wind up IBRC, a decision adopted through the IBRC Act 2013, which also changed an important part of Ireland's corporate liquidation rules. The foreign representatives who sought recognition were special liquidators appointed under public authority and were supervised by the Irish Finance Minister and the High Court of Ireland. US courts recognized the Irish proceedings as main proceedings. They dismissed the argument about the non-applicability of Chapter 15 to "banks," tiptoeing over the question as to whether IBRC was a bank and focusing instead on the fact that it had closed its branches in the US before the request of recognition.<sup>81</sup>

Indeed, the above suggests that, while banks may merit some specialties, there is no *prima facie* reason to exclude the *principles* underpinning cross-border insolvency, such as recognition, creditor protection, non-discrimination, etc. These may offer interpretative criteria to clarify cases where resolution rules are silent. Thus, the question of whether cross-border insolvency rules *do* apply is related to the question of whether they *should* apply, which requires looking carefully at the differences between cross-border insolvency and cross-border resolution. One of those differences concerns the resolution authorities entrusted with the procedure, another concerns the nature and purpose of the procedure itself.

The first objection is not insurmountable. Resolution authorities, rather than courts,<sup>82</sup> may have the preponderant role. However, to be

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<sup>78</sup> UNCITRAL Model Law on Cross-Border Insolvency. Guide to Enactment para. 58.

<sup>79</sup> *Ibid* at 59.

<sup>80</sup> *In re Irish Bank Resolution Corp. Lt.* 2014 WL 9953792, (Bkr. D. Del. 2014), confirmed on appeal in C.A. No. 14-108-LPS (Dist. Ct. Del.) 4th August 2015.

<sup>81</sup> See *In re Irish Bank Resolution Corp. Lt.* 2014 WL 9953792, (Bkr. D. Del. 2014) at 7.

<sup>82</sup> This objection could argue that the extraterritorial projection of regulatory power has traditionally been a strong reason to refuse recognition and enforcement. This has been the reason to refuse recognition and enforcement of tax claims. See *Moore v. Mitchell*, 30

subject to recognition under UNCITRAL rules, court supervision may be potential, rather than actual,<sup>83</sup> and the UNCITRAL Model Law allows recognition of proceedings entrusted to administrative authorities.<sup>84</sup> The courts of *In re Irish Bank Resolution Corporation Ltd* discussed above rejected the objection against recognition of proceedings directed by the Irish Finance Ministry, holding that the proceeding was “administrative or judicial in nature,” that provisions on corporate liquidation applied, and that any creditor could seek a court ruling on issues arising during the proceeding.<sup>85</sup>

Thus, the problem is less about form or subjects than about substantive differences concerning the distributional question of creditor treatment, which constitutes the subject-matter of this study. Cross-border insolvency proceedings must be directed at the general “collective” protection of all creditors,<sup>86</sup> respecting minimum conditions of fairness between them.<sup>87</sup> Proceedings to protect specific creditors or

F.2d 600 (2d Cir. 1929) in the United States, and *Planche v. Fletcher*, (1779) 99 Eng. Rep. 164, 165 (U.K.) in Britain.

<sup>83</sup> UNCITRAL Model Law on Cross-Border Insolvency. Guide to Enactment para. 74. This argument was used to recognize corporate liquidation proceedings. See Australian courts in *Re Chow Cho Poon* construed the law’s scope in a spirit of cooperation to grant recognition to special winding up proceedings under Singapore corporate law as proceedings “pursuant to a law relating to insolvency”. See *Re Chow Cho Poon (Private Limited)* [2011] NSWSC 300.

<sup>84</sup> See article 2 (a), which states that “‘Foreign proceeding’ means a collective judicial or administrative proceeding in a foreign State”, and (e), which states that “‘Foreign court’ means a judicial or other authority competent to control or supervise a foreign proceeding”. The Guide to Enactment at para. 87 states that ‘A foreign proceeding that meets the requisites of article 2, subparagraph (a), should receive the same treatment irrespective of whether it has been commenced and supervised by a judicial body or an administrative body. Therefore, in order to obviate the need to refer to a foreign non-judicial authority whenever reference is made to a foreign court, the definition of “foreign court” in subparagraph (e) includes also non-judicial authorities.’ In *In re Ashapura Minechem Ltd*, 480 B.R.129 (SDNY 2012), US courts considered the India’s Board for Industrial and Financial Reconstruction (BIFR) as a ‘court’. In *Re ABC Learning Centres Limited n/k/a ZYX Learning Centres Limited & ABC USA Holdings Pty Ltd*. No. 10-11711 (KG) (Bankr. Ct. Dist. Del. 16 December 2010) the Delaware courts recognize a foreign liquidation proceeding in Australia despite it was primarily administrative in nature, as it was supervised by a court.

<sup>85</sup> *In re Irish Bank Resolution Corp. Lt.* 2014 WL 9953792, (Bkr. D. Del. 2014), confirmed on appeal in C.A. No. 14-108-LPS (Dist. Ct. Del.) 4th August 2015.

<sup>86</sup> UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective p. 20.

<sup>87</sup> Simon Gleeson “Chapter 5. The Consequences of Chapter 14 for International Recognition of US Bank Resolution Action” in Thomas H Jackson; Kenneth Scott; John Taylor Making Failure Feasible: How Bankruptcy Reform Can End Too Big to Fail Hoover Institution, Stanford University Press, 2015, p. 119.

interests, public or private, are not suitable for recognition. In *Stanford International Bank*, UK courts refused to recognize proceedings ordered by a Texas court, which appointed the SEC as receiver. Courts in Antigua and Barbuda, the place of the bank's registered office, had applied and been granted such recognition first. Thus, the English court considered that (i) the US receiver had to prove and did not try to prove that the entity's COMI was in the US; and, more crucially, (ii) the proceedings were not "pursuant to a law relating to insolvency" because they were not collective proceedings seeking to protect all creditors but rather instituted to prevent fraud and detriment to (US) investors.<sup>88</sup> It is easy to draw a parallel with bank resolution, which seeks to avoid systemic risk and contagion, protect taxpayers and mitigate moral hazard, or preserve critical functions,<sup>89</sup> and conclude that its key differences with insolvency, at the level of principles, justify the non-application of cross-border recognition rules.

Conversely, in *re Irish Bank Resolution Corporation Ltd*, US courts dismissed the objection that because the Finance Minister could give priority to any assets to the Irish State, the Irish Proceeding were not collective in nature. The courts could reject the argument because the IBRC Act 2013 adopted the priority and distribution scheme set forth in the Companies Act and creditors of the same rank distributed proceeds *pro rata*.<sup>90</sup>

Yet all this makes the case against using cross-border insolvency rules in resolution contexts understandable, not justifiable. The UNCITRAL framework does not require principles like court supervision or creditor protection and equal treatment to pervade every aspect of the applicable framework, but to ensure that certain minimum standards are respected. Resolution frameworks *could* and *should* fulfil those minimum requirements. Furthermore, the argument about resolution's specialness requiring a specific framework makes sense only if the alternative to cross-border insolvency is an *ideal* one, which combines the advantages of a robust framework of recognition with the specialties of resolution.<sup>91</sup> Alas, this is far from the *actual* alternative. Doing without cross-border insolvency means having to replace its

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<sup>88</sup> *Re Stanford International Bank Ltd* [2010] EWCA Civ 137.

<sup>89</sup> See Part I, section II.A.

<sup>90</sup> *In re Irish Bank Resolution Corp. Lt.* 2014 WL 9953792, (Bkr. D. Del. 2014) at 14.

<sup>91</sup> Irit Mevorach "Beyond the Search for Certainty: Addressing the Cross-Border Resolution Gap" *cit.* pp. 206-223; Mattias Lehmann "Bail-In and Private International Law: How to Make Bank Resolution Measures effective across Borders" *cit.* pp. 139-142.

principles, and, in practice, cross-border resolution lacks clear legal principles which may constrain unilateral action. Some countries compensate this absence with a non-intrusive bail-in tool, such as the one currently in place in Japan.<sup>92</sup> The United States, by contrast, combines intrusive bail-in powers with a unilateralist system. UNCITRAL Model Law provisions can only apply to foreign banks with no branches or agencies.<sup>93</sup> Foreign banks with (federally-chartered) branches or agencies in the US can be subject to receivership and the receiver can take possession of *all* the property of the foreign bank in the US and liquidate it,<sup>94</sup> or they can be subject to reorganization proceedings by the FDIC (if the branch is deposit-insured) or the Office of the Comptroller of the Currency (“OCC”), which can also appoint a conservator.<sup>95</sup> The procedure is unilateralist and territorialist,<sup>96</sup> with no duty to coordinate with foreign proceedings, and no possibility to send any resources abroad until US creditors are satisfied.<sup>97</sup> In order to coordinate, the OCC or FDIC would need to use their discretion to forbear from appointing a

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<sup>92</sup> Japan Deposit Insurance Act (DIA), for example, includes a general duty of cooperation, with no clear meaning, See Article 137-5 of the DIA. There are no specific rules to solve conflicts of laws, or issues of recognition. Ignacio Tirado “Banking Crisis and the Japanese Legal Framework” *cit.* p. 74. The problem is more serious if recognition is sought for a bail-in decision adopted by a foreign authority in Japan. The opposite case (where the Japanese authority adopts the bail-in decision) is less problematic, because bail-in is restricted to the cases where there is contractual recognition. In an earlier section we justified our attention on the more intrusive regimes, i.e. the US, EU and Swiss ones. *Supra* 2.2.2.1.

<sup>93</sup> *In re awal Bank*, 455 B.r. 73 (Bankr. S.D.N.Y. 2011) and *In re Jsc Bta Bank*, 434 B.r. 334 (Bankr. s.D.n.y. 2010) chapter 15 cases were allowed for a Bahraini bank and a Kazakhstani with no branches or agencies in the US.

<sup>94</sup> Sections 4 (i) – (j) of the International Banking Act 1978. See Paul Lee “Cross-Border Resolution of Banking Groups: International Initiatives and US Perspectives: Part III” *cit.* pp. 299-302.

<sup>95</sup> *Ibid* p. 300.

<sup>96</sup> Steven L. Schwarcz “The Confused U.S. Framework for Foreign-Bank Insolvency: An Open Research Agenda” *Rev. L & Econ.* Vol. 1 (2005) pp. 86-89, who uses the term “xenophobic”.

<sup>97</sup> Section 4 (j) (2) International Banking Act. See Paul Lee “Cross-Border Resolution of Banking Groups: International Initiatives and US Perspectives: Part III” *cit.* p. 303. Branches chartered under state law would be subject to that state’s bank bankruptcy law, which is often equally territorialist. *Ibid* p. 304, who discusses the case of New York Banking Law, as a particularly important example of state law, which follows a ring-fencing approach.

receiver in cases where, for example, a credible bail-in plan will be implemented by foreign resolution authorities.<sup>98</sup>

For large foreign banks subject to the orderly liquidation authority (OLA), and thus with a US holding company, the FDIC must coordinate “to the maximum extent possible” with foreign financial authorities when the bank has assets or operations in countries other than the United States.<sup>99</sup> Yet the provision is drafted in unilateral terms for cases of a US entity with assets abroad, not a foreign entity with assets or operations in the United States. An internationalist could still argue that, even if cross-border insolvency provisions and principles do not apply to resolution, common law principles of recognition and judicial assistance might still be used as backup because they are not expressly excluded by cross-border insolvency law.<sup>100</sup> Nevertheless, the decision to cooperate will fall on resolution authorities and will thus have distinct unilateralist roots.

EU rules are also intrusive but have a clearer framework for the recognition and enforcement of third country proceedings.<sup>101</sup> This includes a procedure to achieve a joint decision by the resolution college on the recognition of foreign procedures, and, absent such joint decision, an individual decision by each of the resolution authorities. The procedure is accompanied by a list of powers that may be exercised in aid of third-country resolution proceedings, including powers to transfer shares and other instruments, or assets and liabilities, and to render unenforceable rights to terminate, liquidate or accelerate contracts.

Still, the rules are completed by a list of circumstances where recognition may be refused, which include the existence of adverse effects on the financial stability of the Member State concerned or another Member State, the need for independent action to achieve some

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<sup>98</sup> See Paul Lee “Cross-Border Resolution of Banking Groups: International Initiatives and US Perspectives: Part III” *cit.* p. 301.

<sup>99</sup> 12 USC § 5390 (a) (1) (N).

<sup>100</sup> Cross-border insolvency provisions only exclude banks from their own application, but not from the application of common law. Samuel I. Bufford, *Tertiary and Other Excluded Foreign Proceedings Under Bankruptcy Code Chapter 15*, 83 *am. Bankr. L.J.* 165, 177-178, (2009); Alesia Ranney-Marinelli, *Overview of Chapter 15 Ancillary and Other Cross-Border Cases*, 82 *am. Bankr. L.J.* 269, 301 (2008) who argues that comity could be obtained from courts other than bankruptcy courts. There are pre-UNCITRAL precedents where US courts allowed ancillary proceedings to begin in their territory for foreign banks with branches/agencies, post-UNCITRAL cases. See *In re Deposit Insurance Agency*, 482 f.3d 612 (2d cir. 2007), *aff’g*, 313 B.r. 561 (s.D.n.y. 2004); *In re smouha*, 136 B.r. 921 (s.D.n.y.), *appeal dismissed*, 979 f.2d 845 (1992).

<sup>101</sup> Article 94 BRRD.

resolution objective, the existence of unequal treatment of creditors in a Member State under the laws of the third country, the existence of material fiscal implications for the Member State in case recognition is granted, or the fact that recognition is contrary to national law.<sup>102</sup> These exceptions pose the greatest danger for cross-border coordination. Whereas the content of some of them is logical, and a matter of principle or right (e.g. the unequal treatment of creditors), others are policy-based and hardly reviewable by courts (e.g. the references to “material fiscal implications” or “financial stability”). Add to this the potentially fractious decision-making process within the resolution college,<sup>103</sup> and this is a recipe for trouble. Fortunately, in purely Eurozone cases, the SRB shall have the preponderant role in assessing whether third-country resolution proceedings shall be recognized but bearing in mind the interest of participating states.<sup>104</sup>

Swiss rules, which contemplate resolution powers that could be potentially troublesome for creditors,<sup>105</sup> are similarly complete and expressly (i) contemplate a universality principle when proceedings are open in Switzerland;<sup>106</sup> (ii) provide for the recognition of foreign resolution action, even in the absence of reciprocity;<sup>107</sup> and (iii) provide for the possibility to put assets located in Switzerland at the disposal of the foreign insolvency estate, subject to the respect of certain creditors rights.<sup>108</sup> However, once again, the rules are drafted in discretionary terms, with no legally enforceable duty.

The degree of discretion and the unilateralist approach in these frameworks may be somewhat tempered through international treaties or agreements between resolution authorities. EU rules on the recognition of foreign resolution proceedings, for example, only apply “unless and

<sup>102</sup> Article 95 BRRD. These roughly correspond to the grounds identified by the FSB. See FSB *Cross-border recognition of resolution action cit.* p. 9.

<sup>103</sup> *Infra* 4.3.

<sup>104</sup> Article 33 (2) para. 3rd Regulation 806/2014 (SRMR) states that: “The assessment shall give due consideration to the interests of each individual participating Member State where a third- country institution or parent undertaking operates, and in particular to the potential impact of the recognition and enforcement of the third-country resolution proceedings on the other parts of the group and the financial stability in those Member States”.

<sup>105</sup> *Supra* 2.2.2.1.

<sup>106</sup> Article 3 BIO-FINMA.

<sup>107</sup> Article 10 BIO-FINMA. Recognition requests absent reciprocity may be granted “where this is in the interests of the creditors affected”.

<sup>108</sup> Article 37g (2) Swiss Banking Act.

until an international agreement as referred to in Article 93(1) enters into force with the relevant third country.”<sup>109</sup> Yet no international treaties have been subscribed, and thus most international cooperation (coordination) is restricted to agreements between competent resolution authorities, which result in crisis-management groups (CMGs) “with the objective of enhancing preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting the firm,” as well as institution-specific Cooperation Agreements (CoAGs).<sup>110</sup> Even if CMGs have been established for all SIFIs and many CoAGs have been signed,<sup>111</sup> the focus of such agreements is primarily cooperation in information exchange and planning, which means that there is no clear pre-commitment to recognize and enforce resolution tools. Furthermore, those agreements are not legally binding for authorities.<sup>112</sup>

Interinstitutional cooperation agreements are supplemented by private sector contractual solutions. The ISDA Protocol for the Stay of Derivatives enforcement<sup>113</sup> and the solutions for contractual bail-in instruments are perhaps the most notable. We will analyse them in greater detail below.<sup>114</sup> Suffice it to say here, however, that the enforcement of these solutions depends on the domestic legal frameworks, where resolution authorities have broad powers to paralyze such enforcement action.

The effort to put in a creating cross-border resolution framework has been formidable. Yet one wonders why it did not include the easiest measure, i.e. to use cross-border insolvency frameworks as background *principles*, which would let resolution arrangements prevail as *lex specialis* but still help to fill gaps. The current all-or-nothing stake on a fuzzy framework of non-binding agreements, private sector contracting, and unilateral goodwill jeopardises the whole system and subverts resolution’s basic premises. It makes sense to reflect resolution’s specialness in a cross-border context; but casting aside cross-border insolvency without alternative principles to replace it results in a loosely-knit framework where authorities have a strong incentive to protect

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<sup>109</sup> Article 94 (1) BRRD.

<sup>110</sup> FSB Key Attributes no. 8.1 and 9.

<sup>111</sup> FSB Ten years on – taking stock of post-crisis resolution reforms Sixth Report on the Implementation of Resolution Reforms 6 July 2017 p. 12.

<sup>112</sup> See, e.g. Framework Cooperation Arrangement between the European Banking Authority (‘EBA’) and US authorities, no. 2.5, 3.1.

<sup>113</sup> ISDA 2015 Resolution Stay Protocol. Available at <http://assets.isda.org/media/ac6b533f-3/5a7c32f8-pdf/>.

<sup>114</sup> *Infra* 5.2.3.



national interest and domestic creditors yet are subject to few constraints. This recklessly jeopardises the swift action and seamless coordination needed to mitigate systemic risk and contagion, and it does not help prevent moral hazard or enhance legal certainty.

The failings of the system are likely to be exposed more clearly when the problem concerns the distributional question of ranking and priorities. Even in cross-border insolvency, where principles are robust, the distributional question is a test case that touches on core policies.<sup>115</sup> There are not two ranking and priority systems that are exactly alike,<sup>116</sup> which can make a “borderline” issue, where the problem lies in the application of a rule, look like a “pivotal” issue, which involves the system’s basic policies and principles hindering cross-border cooperation.<sup>117</sup> Thus, the UNCITRAL provisions on foreign creditors treatment are particularly nuanced to balance the demands of non-discrimination with the need to respect the domestic system of priorities.<sup>118</sup>

Some cases are often cited to show that courts are capable of looking beyond national interests. In *HIH Casualty and General Insurance*,<sup>119</sup> an insurer declared insolvent in Australia had substantial assets in the UK (reinsurance claims corresponding to reinsurance policies taken out in the London market). English courts, including the House of Lords, ordered the transfer of those assets to satisfy insolvency priorities under

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<sup>115</sup> José María Garrido ‘The Distributional Question in Insolvency: Comparative Aspects’ *International Insolvency Review* Vol. 4 (1995) p. 25.

<sup>116</sup> Jose María Garrido ‘No Two Snowflakes the Same: The Distributional Question in International Bankruptcies’ *Texas International Law Journal* Vol. 46 (2011) p. 459.

<sup>117</sup> This situation is well summarized by Westbrook: *From a broad policy perspective, the differences are not crucial, yet each one represents a contentious result in a particular case because one party or another will be advantaged or disadvantaged. Meaningful cooperation among courts will often require that one or the other priority system prevails. The question is whether a court will feel so bound by the local system so as to prevent cooperation with a foreign court.* Jay Lawrence Westbrook ‘Priority Conflicts as a Barrier to Cooperation in Multinational Insolvencies’ *Penn State International Law Review* Vol. 27 (2009) p. 869.

<sup>118</sup> Article 13 of the UNCITRAL Model Law provides that (i) foreign creditors should not be treated worse than local creditors; (ii) this non-discrimination should not affect the local system of priorities; and (iii) this notwithstanding, the application of such system should not lead to foreign creditors ranking lower than ordinary local creditors. Lest the non-discrimination principle should be emptied of its meaning by provisions giving the lowest ranking to foreign claims, paragraph 2 establishes the minimum ranking for claims of foreign creditors: the rank of general unsecured claims.” Guide to Enactment and Interpretation of the UNCITRAL Model Law on Cross-Border Insolvency, para. 119.

<sup>119</sup> *HIH Casualty and General Insurance Ltd*, [2008] UKHL 21.

Australian law, which, unlike UK law, accorded preferential treatment to insurance creditors.<sup>120</sup> But aside from Lord Hoffman's universalist chant, there were other factors at play that made it convenient for UK courts to do without assets located in their territory.<sup>121</sup> In normal circumstances, local authorities would apply their local priority system and lack tools to grant foreign creditors preferential status, other than local law categories. Nevertheless, courts in one country would be ready to grant recognition to resolution action if creditors were treated fairly. As the court in *In re Irish bank* made clear, the key is whether creditors are subject to the foreign country's system of ranking and priorities and whether creditor treatment is roughly similar to the local system.<sup>122</sup> A public policy exception is reserved for serious deviations that leave key interests unprotected.<sup>123</sup>

In resolution rules, on the other hand, there is paucity of detail on the level of deference to third countries when the distributional issue is raised. EU resolution rules exclude some liabilities from bail-in regardless of whether they are subject to the laws of a Member State or

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<sup>120</sup> *Ibid* at [1], [35], the differences that resulted from the application of either the UK system of priorities or the Australian one were listed in a table in [53].

<sup>121</sup> Namely, (i) Australia was one of the jurisdictions included by the Secretary of State among those qualified to receive special assistance; (ii) due to the implementation of EU insurance rules, Britain was about to enact an insurance creditors' priority similar to the Australian, which made the divergence temporary, and thus, arguably, not a matter of policy; (iii) protection of foreign creditors enhanced London's pre-eminence as an insurance centre; and (iv) the conflict in the case was between foreign priorities and the local *pari passu* principle (protective of unsecured creditors), which, in a taxonomy of priority conflicts, would be of a less intense kind than that between foreign and local priorities. See Jose Maria Garrido 'No Two Snowflakes the Same: The Distributional Question in International Bankruptcies' op. cit. pp. 463-465. See also Jay Lawrence Westbrook 'Universal Priorities' *Texas International Law Journal* Vol. 33 (1998) pp. 30-32, 40; Sefa Franken 'Three Principles of Transnational Corporate Bankruptcy Law: A Review' *European Law Journal* Vol. 11 (2005) p. 239.

<sup>122</sup> 'Appellants suggest (largely through a series of questions, see D.I. 34 at 1 18) that the Irish Proceeding discriminates against U.S. creditors and deprives them of due process and other unspecified constitutional rights, in favor of benefitting the Irish government. As Appellees persuasively respond, the provisions objected to by Appellants parallel provisions in laws adopted by the United States in response to the global financial crisis.' *In re Irish Bank Resolution Corp. Lt.* C.A. No. 14-108-LPS (Dist. Ct. Del.) 4th August 2015 (appeal decision).

<sup>123</sup> *In Re Qimonda AG Bankr. Lit.* 09-14766-RGM; 09-14766-SSM 433 B.R. 547; 462 B.R. 165 Bankr. E Dist. Vir. (2011), US courts considered that the German procedure insufficiently protected the rights of the licensee under an IP licensing contract (US provisions would grant the licensee a choice, whilst the foreign representative indicated its intention not to perform the contracts).

of a third country,<sup>124</sup> even if they would have to fit within the categories envisaged by EU law. The laws of Switzerland could be construed in a similar manner, considering the liberal approach they adopt towards third-country proceedings and the absence of discriminatory provisions regarding the rights of preferential creditors.<sup>125</sup>

US law contains no express reference to the laws of third countries, but the ranking stipulated for unsecured creditors<sup>126</sup> should not be interpreted as being restricted to instruments subject to US law. The only exception would be government claims, where the rules that rank them as second in priority only to administration expenses expressly refer to “amounts owed to the United States,” thus excluding liabilities owed to other governments. Liabilities of foreign creditors would need to fit within the categories envisaged by US law (e.g. administration expenses, employee rights, or post-resolution financing),<sup>127</sup> but should enjoy the same ranking. The outcome is difficult to envisage because resolution authorities have discretion to benefit specific classes of creditors<sup>128</sup> but they may be constrained by allegations of discrimination by US creditors.

This takes us back to the policy drawing room.<sup>129</sup> Unilateral approaches lead to a sub-optimal equilibrium of liquidity supply, and this conclusion should not change much if liquidity does not come from bail-outs, but from bail-ins: lack of trust between local authorities of different jurisdictions leads to uncoordinated unilateral action that constrains liquidity and increases instability. In terms of the “trilemma” between global financial stability, global banks, and domestic authorities,<sup>130</sup> the latter have not been sacrificed, but strengthened. This, in principle,

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<sup>124</sup> Covered deposits, secured liabilities, liabilities arising from holding of clients assets or money or fiduciary relationships, liabilities under 7 days, liabilities from accrued salary, pension benefits or other fixed remuneration, commercial or trade creditors, or tax or social security authorities would be covered regardless of the law governing the relationship. See article 44 (2) BRRD.

<sup>125</sup> Article 37 Banking Act, articles 3, 10, 35, 47 BIO-FINMA.

<sup>126</sup> 12 USC §§ 5386 (3), 5390 (a) (1) (M), and 5390 (b).

<sup>127</sup> 12 USC § 5390 (b) (1) (A), (C), (D) or (2).

<sup>128</sup> 12 USC § 5390 (b) (4).

<sup>129</sup> See section II.A.

<sup>130</sup> Dirk Shoenmaker “The financial trilemma” *Economic Letters* 111 (2011) pp. 57-59; Stijn Claessens; Richard J. Herring; Dirk Shoenmaker; Kimberly A. Summe “A Safer World Financial System: Improving the Resolution of Systemic Institutions” *Geneva Reports on the World Economy* 12 (2010) p. 32.

comes at the expense of global financial stability. In section IV we will explore how this is mitigated by sacrificing global banks.<sup>131</sup>

### III. CROSS-BORDER RESOLUTION AND KEY OPERATIONAL LIABILITIES

Having seen how the general framework of cross-border resolution is mired in uncertainty, we proceed now to analyse how this affects specifically the different types of bank liabilities used in previous sections. We discuss deposits (A) arrangements for liquidity and collateral, and hedging and derivatives (B), and subordinated and non-preferred debt (C).

#### A. *Deposits: Cross-border resolution, local preferences, and the risks of parochialism*

In the first part of this study, we illustrated how resolution frameworks have been specifically tailored to protect depositors.<sup>132</sup> The goal is to ensure that the financial backstop does not turn into a bank subsidy. In a domestic setting, this logic works impeccably since financial backstops and resolution authorities belong to the same jurisdiction and their interests are aligned. Indeed, the same authority that manages the resolution fund may also be the resolution authority, as is the case with the FDIC in the US.<sup>133</sup> In cross-border cases, however, foreign branch deposits may not be covered by the domestic deposit guarantee scheme. Granting them the same protection in insolvency or resolution could be seen as an implied subsidy to the foreign deposit guarantee scheme and/or encourage supervisory laxity by host authorities. These tensions can result in (i) conceptual problems around what constitutes a protected deposit, and (ii) policy problems relating to the status that should be granted to domestic deposits *vis-à-vis* foreign deposits.

Conceptual problems can arise even in cases where the insolvency-resolution protection is not disputed. In the *Aresbank* case, decided by

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<sup>131</sup> *Infra* 5.3.

<sup>132</sup> See Part I, section III.A.1.

<sup>133</sup> 12 U.S.C. 1811(a) and (b).

the EFTA court,<sup>134</sup> Aresbank, a Spanish bank, granted a loan to Landsbanki, an Icelandic bank, which did not enter the debt as a deposit in its books, nor were the funds placed, nor were special documents regarding the receipt of funds issued, nor were premiums paid to the Depositors' and Investors' Guarantee Fund in respect to the funds.<sup>135</sup> After the meltdown of the Icelandic banking system, the Icelandic financial supervisory authority (FME) took over the functions of Landsbanki's board and set up a bridge institution which, according to the FME, should take over obligations "of the branches of Landsbanki in Iceland due to deposits from financial undertakings, the Icelandic Central Bank and other customers." The EFTA Court held that despite the peculiar circumstances in which the Aresbank loan was originated, and despite the fact that, as an inter-bank deposit, it was not eligible for repayment under the deposit guarantee scheme, it was still transferred to the bridge institution under the FME decision.

Since the case was based on an interpretation of a specific decision of the financial authority rather than a set of legal rules it is unclear whether its conclusions have any precedential value. Interbank deposits are not excluded from bail-in, but short-term funding is, at least in the EU.<sup>136</sup> Thus, if a short-term liquidity facility is concluded between a bank soon to be in resolution and a creditor, e.g. another bank, the latter only needs to structure it as a loan rather than a deposit to be redeemed in the short-term. More problematic, however, could be the case of countries like Italy, which exclude all deposits, including corporate and interbank deposits, from bail-in.<sup>137</sup>

The policy problems concern the treatment of domestic deposits *vis-à-vis* foreign deposits, which can have regional (e.g. intra-EU) or fully international dimension. In an intra-EU context, the difficulty can arise from the expanded privilege granted to deposits in countries such as Italy, which include large corporate deposits, or inter-bank deposits.<sup>138</sup> This could create difficulties in cases where two entities that are located in different EU countries (e.g. Italy and Spain), which have a liquidity

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<sup>134</sup> Case E-17/11 Aresbank SA and Landsbankinn hf., Fjármálaeftirlitið (the Financial Supervisory Authority) and the Icelandic State 22 November 2012.

<sup>135</sup> *Ibid* at 47.

<sup>136</sup> Article 44 (2) (a) BRRD.

<sup>137</sup> See Part I, section IV.A.2.

<sup>138</sup> These preferences were established to comply with rules on Minimum Requirements on Eligible Liabilities (MREL) without having to issue new debt. See Part I, section IV.A.

arrangement involving deposits on each other, are put into resolution and Italian authorities are asked to enforce the bail-in of the deposits held by the Italian entity in the Spanish one, while the deposits by the Spanish entity in the Italian one are excluded from bail-in. The case may be worse when deposits are one of the tools that several related entities (in a group or not) use for liquidity management purposes. In that case, having recourse to the *ad hoc* exclusion under article 44(3) of the BRRD may not be justified because it is reserved for “exceptional” cases, and yet the bail-in of such deposits may still be extremely disruptive.

In a fully international context, some jurisdictions have introduced domestic deposit preference regimes. A notable case is the US, where the deposit preference was introduced in 1993<sup>139</sup> but the definition of “deposit” left out foreign deposits, something that was confirmed by FDIC interpretations.<sup>140, 141</sup> The EU framework is less drastic but it also shows a clear difference in treatment. BRRD rules formulate an insolvency preference for foreign retail deposits, i.e. deposits that would be “eligible deposits” for full protection purposes were they not made through foreign branches, which will rank above ordinary creditors.<sup>142</sup> However, these will still rank below domestic retail deposits which are

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<sup>139</sup> Section 11(d)(11)(A) of the Federal Deposit Insurance Act (“FDIA”), at 12 U.S.C. § 1821(d)(11)(A). It was introduced by the Omnibus Budget Reconciliation Act 1993 (OBRA93). See James B. Thomson “The National Depositor Preference Law” *Federal Reserve Bank of Cleveland* (February 15, 1994).

<sup>140</sup> Christopher Curtis “The Status of Foreign Deposits under the Federal Depositor-Preference Law” *University of Pennsylvania Journal of International Law* Vol. 21 (2000) p. 237. See also James A. Marino; Rosalind Bennett “The Consequences of National Depositor Preference” *FDIC Banking Review* (1999) p. 19.

<sup>141</sup> The financial crisis stirred controversy over its impact. The UK FCA issued a consultation paper stating that foreign firms should be prohibited from accepting deposits through their UK branch, the only options being (i) setting up a subsidiary, (ii) the elimination of domestic priorities, or (iii) making deposits payable both in host and home jurisdictions. See Financial Services Authority (FSA) *Addressing the implications of non-EEA national depositor preference regimes* Consultation Paper CP 12/23 (September 2012).<sup>141</sup> The reaction by some firms was to structure deposits to ensure that they were payable in both jurisdictions. See, e.g. David Polk “FDIC Proposal on Foreign Branch Deposits: Dual Payability, Depositor Preference and Deposit Insurance”. Client Memorandum (February 15, 2013); Shearman & Sterling “Preferring Foreign Depositors” Client Alert (April 10, 2013).<sup>141</sup> To this, the FDIC reacted by explicitly excluding from deposit preference dually payable deposits from foreign branches. FDIC “Deposit Insurance Regulations; Definition of Insured Deposit. Final Rule” 12 C.F.R. Part 330.<sup>141</sup>

<sup>142</sup> See Article 108 (a) (ii) BRRD. The treatment is the same for the amounts exceeding the coverage level.

“covered deposits”, and the subrogation claims of Deposit Guarantee Schemes (DGS).<sup>143</sup>

Domestic deposit preference regimes are a clear example of how the logic of resolution policies can be turned on its head when goals and means are not fully aligned. It makes sense to have resolution rules to mitigate contagion and systemic risk. Protecting deposits enhances trust in the system. However, when rules designed to achieve those ends are administered in a global system by local authorities, these will minimize the cost for the latter (and local taxpayers) in a way that may undermine trust and instability, thereby achieving the opposite goal. This is a clear application of the international “trilemma” logic outlined above,<sup>144</sup> with surprising and harmful results.

The policy flaws may be clear, but the implications for a principles-based interpretation are less so. The different treatment of domestic branch and foreign branch deposits may be justified when it comes to the right to reimbursement, which is a right against the DGS, and it is based on the contributions made for those deposits to that same DGS. When the difference is used to determine deposit preferences, however, it means that the exact same kind of right (arising from a deposit) against the exact same entity (branches lack legal personality) is discriminated against without a clear justification. Transparency rules try to ensure the client’s awareness of the applicable coverage,<sup>145</sup> but such rules are far from perfect<sup>146</sup> and do not eliminate the pervasive question of which of the system’s policies are being furthered by the difference in treatment. The discrimination can hardly mitigate moral hazard, bolster financial stability or preserve critical functions, and it undermines trust in international banking, which is hardly a resolution policy. If anything, it might reduce taxpayer exposure, but only if deposits were reimbursed with public money, which is not typically the case. If cost-saving is the underpinning logic, the same could be achieved if blue-eyed or male

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<sup>143</sup> See Article 108 (b) BRRD. For a detailed analysis of the treatment of different types of deposits under the BRRD, see Part I, section III.A.1.

<sup>144</sup> See section II.A.

<sup>145</sup> Article 16 DGS Directive. The template for such information is set out in Annex I of the Directive, and the depositors shall acknowledge the receipt of that information before entering contract of deposit. See article 16 (2) DGS Directive.

<sup>146</sup> In the EU, the rules only require disclosure of the *information of the DGS* of which the institution and its branches are members *within the Union*. Article 16 (1) DGS Directive. Furthermore, there is *no comparable duty of disclosure of the information on the deposit’s ranking* in case the EU bank were to be subject to insolvency proceedings, or resolution and bail-in. This leaves the depositor unprotected and unaware of such lack of protection.

depositors were singled out for discrimination. The difference is that in such case the arbitrariness of the measure would become plainer.<sup>147</sup>

### B. *Liquidity (Cash and Collateral) and Hedging Arrangements: Characterizing the Uncharacterizable*

Collateral arrangements are key to ensure a bank's liquidity management. In order to ensure that liquidity management runs smoothly, there needs to be certainty in the execution of the different collateral arrangements underpinning these transactions. Yet, for purposes of validity, enforcement, and recognition, security interests are subject to the laws of the place where the assets are located (*lex rei sitae*), the laws of the place of the grantor of the security right,<sup>148</sup> or the laws of the place of the register for non-possessory security rights over receivables.<sup>149</sup>

In cases of “*financial collateral arrangements*,”<sup>150</sup> the rules are more specific and rely on the law chosen by the intermediary and the securities holder in the US<sup>151</sup> or the law of the place of the relevant securities account (PRIMA approach) in the EU.<sup>152</sup> This offers a more certain set of possibilities, but it can create difficulties in some situations. The first difficulty is posed when financial collateral arrangements are subject to a single “master agreement” but the securities collateral are deposited in several jurisdictions. The second arises when, in the case of cross-border custody chains,<sup>153</sup> a client may have a securities account with a bank as

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<sup>147</sup> For a detailed analysis of the potential of fundamental rights, including the principle of non-discrimination, as a limit to bail-in, see Ramos, D. and Solana, J., “Fundamental rights: A Limit to bail-in?” (forthcoming 2019).

<sup>148</sup> UNCITRAL Legislative Guide on Secured Transactions pp. 384 *et seq.*

<sup>149</sup> Sections 860 and 869 of the UK Companies Act 2006 (charges and Companies House). See also, e.g. article 1 (4) Italian Decree Law n. 59 of 2016, or articles 67 *et seq.* of the Spanish Act on Mortgage over Movables and Non-Possessory Pledge.

<sup>150</sup> The term “financial collateral arrangements” defines the scope of application of the Financial Collateral Directive (FCD) in the EU. For a detailed definition, see article 2 FCD.

<sup>151</sup> Sections §§ 8-110 (b) and (e), and 9-305 (a) (3) of the Uniform Commercial Code. See also article 4 (1) of the Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary.

<sup>152</sup> Article 9 (1) FCD. Sections §§ 8-110 (b) and (e), and 9-305 (a) (3) of the Uniform Commercial Code also refer to the “securities’ intermediary jurisdiction”, but let the parties determine this through their agreement, which *de facto* makes

<sup>153</sup> See, e.g. ESMA *Call for Evidence. Asset segregation and custody services* 15 July 2016 | ESMA/2016/1137, and the response by ECSDA CSDs, asset segregation, and



custodian 1, but that bank may hold both its proprietary securities and its clients' securities with custodian 2, which is established in another jurisdiction. The situation can be extremely complex if custodian 2 fails and securities are commingled.

This is compounded by the fact that some bespoke collateral arrangements may be difficult to classify and characterize in terms of existing security arrangements. This can create problems if the security interest is "floating"<sup>154</sup> over all present and future assets. In the *Lehman (Extended Liens)* case, the problem was how to classify a clause in the liquidity management arrangement.<sup>155</sup> This was a boilerplate clause used in custody agreements with Lehman customers, but used for intra-group liquidity management purposes: one group entity agreed to grant another group entity as "custodian" a "general lien on all property held by it" under the agreement.<sup>156</sup> Justice Briggs noted that, under English law, a "lien" is a possessory security and therefore cannot fall over intangible assets. He concluded that, since the arrangement granted the "client" (group entity) control over the funds, it was a floating charge subject to registration which had not been fully registered. Lastly, Briggs examined whether the "lien" could be characterized as a "financial collateral arrangement" protected by the 2002 Financial Collateral Directive (FCD),<sup>157</sup> which he rejected on the basis that the collateral taker (charge) did not have 'possession or control' over the collateral assets, as required by the FCD.<sup>158</sup>

Let us now consider this situation on a cross-border basis. An "omnibus" account that relies on some kind of "floating" security interest may be subject to the laws of countries that contemplate this kind of security interest (e.g. UK or Sweden) but may rely on collateral deposited in countries that do not contemplate it (e.g. Spain) or where its status is not clear (e.g. Italy).<sup>159</sup> Authorities would have to decide, first, if the security is a "financial collateral arrangement" subject to specific

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custody services under UCITS and AIFMD, 23 September 2016. See also Diana Chan; Florence Fontan; Simonetta Rosati; Daniela Russo "The Securities Custody Industry" *ECB Occasional Paper Series* No. 68 (August 2007).

<sup>154</sup> For a discussion of the treatment of collateral arrangements, and especially floating securities, see Part I, section III.A.2.

<sup>155</sup> *Lehman Brothers International (Europe) (in administration)* ([2012] EWHC 2997 (Ch)).

<sup>156</sup> *Supra* 3.1.2 for the text of the clause.

<sup>157</sup> Directive 2002/47/EC, of 6 June 2002, on Financial Collateral Arrangements.

<sup>158</sup> For a more detailed discussion, see Part I, section III.A.2.

<sup>159</sup> For a detailed analysis, see Part I, section III.A.2.

rules such as the FCD, and they might differ in their appraisal of the “possession or control” requirement, some considering the arrangement to be subject to FCD rules, others not. In cases falling outside FCD rules, authorities would have to consider the validity and enforceability of rights under the *lex rei sitae*, for example, which could result in different conclusions depending on the assets’ “location”: an uncertain status under Spanish or German law, a less preferential insolvency treatment in the UK, and a priority over 55% of the insolvent firm’s assets in Sweden.<sup>160</sup> Yet, the bail-in tool can only have a binary effect on the secured liabilities: either they are “in” or “out” of bail-in. In a cross-border context, it would be impossible to give such a definitive answer.

These difficulties will also affect secured liabilities arising from derivatives, whose treatment in insolvency law also differs among Member States.<sup>161</sup> Resolution authorities will rely on the law of the home Member State of the institution,<sup>162</sup> which can create problems if it allocates losses to creditors under derivatives contracts governed by the law of a different country or residing in another country. Within the EU, the rules guarantee recognition and the risk of a discrimination claim looks remote, but a truly differentiated treatment could give the affected creditors a right to challenge the actions adopted.<sup>163</sup>

Outside such an integrated framework, and absent cooperation agreements with third-country resolution authorities,<sup>164</sup> resolution authorities of EU Member States could reject the recognition of third-

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<sup>160</sup> For a detailed analysis, see Part I, section III.A.2.

<sup>161</sup> For a discussion of the treatment of derivatives, see Part I, section III.A.3.

<sup>162</sup> See BRRD, art 48(1)(e); Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, art 10(2)(h).

<sup>163</sup> See BRRD, arts. 85 and 66(6)(b). A differentiated treatment would still be subject to the limit of non-discrimination. See e.g. European Convention of Human Rights, art 14; Charter of Fundamental Rights of the European Union, art 21. Paragraph 13 of the Preamble of the BRRD expressly recognises the need of resolution actions to be compatible with the Charter of Fundamental Rights of the EU. It adds: ‘In particular, where creditors within the same class are treated differently in the context of resolution action, such distinctions should be justified in the public interest and proportionate to the risks being addressed and should be neither directly nor indirectly discriminatory on the grounds of nationality.’ See also paragraphs 29 and 47 of the Preamble to the BRRD. Derivatives counterparties could challenge the resolution proceeding initiated in country A by challenging the validity of the creditor ranking under the law of country A. See BRRD, arts 85(2) and (3). For a detailed analysis of how anti-discrimination claims may constitute a limit to the effective application of bail-in, see Ramos and Solana, “Fundamental rights: A limit to bail-in?” (forthcoming 2019).

<sup>164</sup> See BRRD, arts 93(1) and (2), 97(3)(e).

country resolution proceedings on several grounds: if the treatment of derivative contracts were to threaten the financial stability of any Member State; if it were to have material fiscal implications for that Member State; if its effects were contrary to the national law; or if creditors “would not receive the same treatment” as third-country creditors and depositors.<sup>165</sup> The risk would be the same if EU resolution authorities sought recognition of their bail-in measures over derivatives claims in third countries.

Rather than harmonising creditor priorities, the laws should eliminate disparities in treatment based on nationality or residence for creditors under the same type of instrument. Yet the FSB merely recommends transparency about the priority rankings for different creditors. The paucity of details of domestic and regional systems have prompted private sector solutions. These, however, have focused on securing a stay of enforcement of derivatives contracts through the ISDA protocol to its Master Agreement,<sup>166</sup> which has been adhered to by most dealer banks,<sup>167</sup> and cannot guarantee that the rights arising from those contracts will be treated equally.

### *C. Subordinated and Non-preferred Debt: The Relationship Between Different Debt Types*

To mitigate the frictions between resolution and insolvency priorities, regulatory rules require banks to have an adequate cushion of debt that is easy to bail-in in order to ensure its loss-absorbency capacity (TLAC).<sup>168</sup> In a cross-border context, however, this will only work if a bail-in decision by a resolution authority is enforced by another resolution authority. This depends on the cross-border recognition of resolution action, which, save for regional cases, like the EU, is quite uncertain.<sup>169</sup>

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<sup>165</sup> BRRD, arts 94(3), second sub-paragraph, 95(a) (financial stability), 95(d) (material fiscal implications), art 95(e) (effects contrary to the law) and art 95(c) (unequal treatment).

<sup>166</sup> ISDA 2015 Resolution Stay Protocol. Available at <http://assets.isda.org/media/ac6b533f-3/5a7c32f8-pdf/>

<sup>167</sup> See the adhering parties at <http://www2.isda.org/functional-areas/protocol-management/protocol/22>

<sup>168</sup> We explore these functions and the rationale for TLAC in greater detail in Part I, section 4.A.

<sup>169</sup> See section II.

In light of such uncertainty, the FSB has pressed for private sector solutions consisting in model clauses that, once included in debenture agreements, will provide a contractual basis for the recognition of bail-in in countries whose laws regulate the debenture agreement.<sup>170</sup> The FSB has stressed some contents that the clauses should have, including the following:<sup>171</sup> (i) a clear agreement by the debt holder to be bound by the terms of the bail-in under the relevant resolution; (ii) a clear disclosure of the bail-in term to the debtholders in the relevant jurisdictions; (iii) the use of general terms, to ensure that the clause merely *recognizes* bail-in, but that bail-in itself results from the resolution authority's decision, in the terms dictated by that resolution authority, not from contract terms;<sup>172</sup> and (iv) the requirement of a legal opinion by experts in the jurisdiction concerned stating that the clause should result in the enforceability of bail-in action in that jurisdiction.

The BRRD is aligned with this approach, and requires bank entities to prove that the debt can be bailed-in under the laws of the country to which the instruments are subject to "having regard to the terms of the contract governing the liability, international agreements on the recognition of resolution proceedings and other relevant matters."<sup>173</sup> The rules also require banks [*insert a verb* here] a legal opinion about the effectiveness and legal enforceability of the clause.<sup>174</sup> In line with the FSB proposals, the European Banking Authority (EBA) developed specific technical standards for the contractual recognition of bail-in, such as the contents that a clause should have.<sup>175</sup>

Different model clauses are offered to their subscribers by industry associations such as the International Capital Markets Association

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<sup>170</sup> FSB *Cross-border recognition of resolution action cit.* p.13.

<sup>171</sup> FSB *Cross-border recognition of resolution action cit.* p. 14.

<sup>172</sup> Thus, if write-down or conversion of the debt is envisaged in other circumstances, such as a downgrading or default, the clause should make clear that this instance is completely separate from the one where bail-in powers are exercised

<sup>173</sup> Article 55 BRRD.

<sup>174</sup> Article 55 (1) 3rd para. BRRD.

<sup>175</sup> EBA Final Report. *Draft Regulatory Technical Standards on the contractual recognition of write-down and conversion powers under Article 55(3) of Directive 2014/59/EU* EBA/RTS/2015/06 03 July 2015 (hereafter: EBA RTS Contractual Bail-in). The minimum content of contractual bail-in clauses includes a description of the resolution powers of the relevant resolution authority; and an acceptance that the liability may be subject to bail-in, that the holder will be bound by the effect of resolution powers; and that the contract term is exhaustive on the matters described, to the exclusion of other agreements, arrangements or understandings. Article 3 EBA RTS Contractual Bail-in.

(ICMA),<sup>176</sup> the Loan Market Association (LMA) or the Loan Syndications and Trading Association (LSTA).<sup>177</sup> The only one that is publicly available was drafted by the Association for Financial Markets in Europe (AFME), which is conceived for issuers of debt securities organized in the UK in debt securities offerings governed by New York law,<sup>178</sup> although AFME is working in other versions for different circumstances. The absence of public availability of some such clauses, however, can hinder public awareness.

Transparency and clarity of interpretation fostered by uniformity are key to success. Problems may arise not only from a flat refusal by authorities or courts to enforce bail-in. Recognition of bail-in is only the first step. A second problem, once bail-in is recognized, is what status should the different kinds of subordinated or non-preferred debt enjoy with respect to each other. We illustrate this with three examples.

A first situation may concern the “equivalence” between different types of debt. French provisions on Tier 3 debt apply not only to instruments issued under French law but also under the laws of a different EU Member State provided they present “analogous characteristics” to the instruments described under those provisions.<sup>179</sup> The question is whether an ordinary bond subject to German law, where subordination is required by statute, presents “analogous characteristics” to a French Tier 3 bond, where subordination results from a combination of the law, on one hand, and the bonds’ terms and conditions, on the other. The case may be even less clear with a bond subject to Spanish law, for example, that includes a subordination clause; but only because Spanish statutory rules use subordination to fulfil a similar function to “non-preferred” debt in other jurisdictions.

A second situation may arise if debt that is non-preferred, or subordinated as a matter of contract, competes with debt that is subordinated as a matter of statute; for example, if Tier-3 or subordinated debt sits alongside ordinary bonds issued by a German bank, which are subordinated by bank insolvency law,<sup>180</sup> or alongside debt issued by a Spanish bank and held by a related party, which is subordinated by

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<sup>176</sup> ICMA included bail-in terms in its Agreement Among Managers that forms part of the ICMA Primary Markets Handbook. See <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/ipma-handbook-home/>

<sup>177</sup> <http://www.lma.eu.com/documents-guidelines/documents/category/bailin-clause#>

<sup>178</sup> <http://www.afme.eu/Documents/Standard-forms-and-documents.aspx>.

<sup>179</sup> Article L-613-30-3 4° (b) and (c) French Monetary and Financial Code. We describe Tier 3 debt in greater detail in Part I, section IV.A.2.

<sup>180</sup> See Part I, section IV.A.2.

general insolvency law.<sup>181</sup> Statutory provisions could support the subordination of contractually subordinated debt to ordinary senior debt under German law, but the status of Tier-3 debt *vis-à-vis* ordinary debt in German law, or of contractually subordinated debt *vis-à-vis* statutorily subordinated intra-group debt in Spanish law, would be unclear.

A third situation may arise when there is no clear framework for equivalence, as is the case between the US and the EU. What status non-preferred or subordinated bonds, subject, respectively, to French law and New York law, would enjoy with respect to each other is unclear. In that case, the presumably boilerplate clauses would be subject to interpretation by the courts. It is unclear what courts would make of multiple “non-preferred” and “subordination” clauses. Precedents show that even the meaning of well-established clauses can be reassessed, as it happened in *NML v Argentina*, with a *pari passu* clause in a sovereign debt offering.<sup>182</sup> Sovereign debt differs from bail-in-able bank debt, but it

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<sup>181</sup> See Part I, section III.B.1.

<sup>182</sup> The Argentinian government had issued sovereign bonds subject to a Fiscal Agency Agreement (FAA) that contained a *pari passu* clause with broad language. It read: “The Securities will constitute [...] direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank *pari passu* and without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness”. Fiscal Agency Agreement between the Republic of Argentina and Bankers Trust Company, Oct. 19, 1994, quoted in *NML Capital, Ltd. v. Argentina*, 699 F.3d 246 (2d Cir. 2012). NML, a vulture fund, acquired bonds in the secondary market at a discount. After its default in 2001 Argentina issued a moratorium on payments of all bonds, including FAA bonds, and, in 2005 and 2010, as part of its debt restructuring efforts, it offered bondholders to exchange their bonds for new, unsecured, unsubordinated, debt, which included a discount (i.e. the new bonds had a lower value than the older bonds). Yet, Argentina relied more on ‘sticks’ than ‘carrots’, as it included in the prospectus of the new bonds its intention to discontinue payments of the older bonds, including FAA bonds. To make good on this promise, it passed Law 26.017 (“Lock Laws”) which included a prohibition to the Argentinian State “from conducting any type of in-court, outof-court or private settlement with respect to the bonds.” Afterwards, it discontinued payment of the older bonds. NML sued Argentina before NY courts for having defaulted on its bonds. See *NML Capital, Ltd. v. Argentina*, No. 08 Civ 6978 (TPG) (S.D.N.Y. Feb. 23, 2012) (decision granting preliminary injunction); *NML Capital, Ltd. v. Argentina*, 699 F.3d 246, 264 (2d Cir. 2012) (decision on appeal confirming Judge Griesa’s opinion, but remanding the case to clarify the meaning of ‘ratable payment’); *NML Capital, Ltd. v. Argentina*, No. 08 Civ 6978 (TPG), 2012 U.S. Dist. LEXIS 167272 (S.D.N.Y. Nov. 21, 2012) (decision holding that ‘ratable payment’ meant that, if Argentina paid 100% of the Exchange Bonds, that it had issued in exchange for the older bonds in a debt restructuring not accepted by NML, it would have to pay 100% to NML for their bonds); *NML Capital, Ltd. v. Republic of Argentina*, 727 F.3d 230 (2d Cir. 2013) (decision by the Court of Appeals affirming

offers useful lessons. One is that courts can adopt controversial interpretations.<sup>183</sup> The other is that, even if courts adopt a conventional stance, the criteria used to interpret contract language that is boilerplate in nature are unclear, which means that any interpretation will have a sizeable impact on market efficiency and stability.<sup>184</sup> If such “public” considerations form part of the assessment, there is no guarantee that they will make the courts lean towards an “internationalist” stance. Courts or authorities in the United States could read a decision by French resolution authorities prioritizing Tier-3 debt subject to French law over subordinated debt instruments subject to US law as an attempt to “import” the French system of insolvency priorities into the US jurisdiction, and therefore refuse enforcement.

#### IV. THE INTRA-GROUP DIMENSION IN A CROSS-BORDER CONTEXT

In this section, we bring together the perspectives adopted at each layer: the intra-group dimension, the crisis-prevention and crisis-management dichotomy, and the cross-border dimension. First, we

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Judge Griesa’s holding). See Natalie Wong ‘NML Capital, Ltd. v. Republic of Argentina and the Changing Roles of the *Pari Passu* and Collective Action Clauses in Sovereign Debt Agreements’ *Columbia Journal of Transnational Law* Vol. 53 (2015) p. 396; Romain Zamour, ‘NML v. Argentina and the Ratable Payment Interpretation of the *Pari Passu* Clause’ *Yale Journal of International Law Online* Vol. 38 (2013) p. 55, for excellent case notes.

<sup>183</sup> For critical views on the interpretation of *pari passu* clauses, see Mitu Gulati; Kenneth N. Klee ‘Sovereign Piracy’ *Business Lawyer* Vol. 56 (2001) p. 635, taking issue with the court’s interpretation of *pari passu* clauses in *NML v Argentina*’s immediate precedent, *Elliott Associates, L.P. v. Banco de la Nacion*, 194 F.R.D. 116 (S.D.N.Y. 2000); Lee Buchheit; Sofia Martos ‘What to do About *Pari Passu*’ *Butterworths Journal of International Banking and Financial Law* (2014), or Theresa A. Monteleone ‘A Vulture’s Gamble: High-Stakes Interpretation of Sovereign Debt Contracts in *NML Capital, Ltd. v. Argentina*’ *Capital Markets Law Journal* Vol. 8 (2013) p. 149.

<sup>184</sup> For a conventional analysis of interpretation and gap-filling in contracts, see See, e.g. Ian Ayres; Robert Gertner ‘Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules’ *The Yale Law Journal* Vol. 99 (1989) p. 87. Experts in the sovereign debt market have argued that boilerplate contract clauses that are re-used over and over again cannot be treated as a normal case of gap-filling. See Mitu Gulati; Robert Scott *The 3 ½ Minute Transaction: Boilerplate and the Limits of Contract Design* The University of Chicago Press, 2013; Mitu Gulati; Kenneth N. Klee ‘Sovereign Piracy’ *Business Lawyer* Vol. 56 (2001) p. 635. A study suggests that sophisticated lawyers are prone to “mythical” and “ritualistic” thinking, which decouples the lawyer’s understanding of what he is doing from what the clauses indicate. See Mark Weidermaier; Robert Scott; Mitu Gulati ‘Origin Myths, Contracts, and the Hunt for *Pari Passu*’ *Law and Social Inquiry* Vol. 38 Issue 1 (2013) pp. 72-115.

discuss how the uneven treatment of intra-group debt can endanger critical functions and jeopardise cross-border coordination of resolution action (A). Second, we examine how, in order to avoid those problems with resolution action, *ex ante* planning tools are deployed to try to accomplish a balkanization of international banking (B).

A. *Cross-border groups and ex-post crisis management: the risks of uneven treatment for critical functions and cross-border coordination of resolution action*

Examining the cross-border, intra-group perspective of bank resolution and insolvency ranking requires an analysis from two angles, one concerning policy and principle, and another concerning procedure. From the perspective of policy and principle, intra-group transactions are looked at with suspicion. Countries like Spain or Germany subordinate shareholder loans or intra-group loans and equivalent transactions. Others, like Italy, subordinate shareholder loans when they are “equity replacing”, while others have no special treatment. The cross-border setting adds an inconsistency between the approaches to those intra-group transactions in different jurisdictions. Since cross-border banking groups continue to report intra-group funding structures, there is a clear risk if the corresponding rights and liabilities are (i) subject to subordination; and/or (ii) not treated consistently, with the potential risk of disrupting basic operations. There are several issues that require our attention.

The first issue concerns intra-group funding mechanisms through loans. In countries, like Italy, that only subordinate “equity replacing” loans, intra-group funding structures could be spared from subordination by way of interpretation since they do not result in a constant and stable funding from parent to subsidiaries through debt in a way that resembles equity financing. On the other hand, in countries where subordination is automatic, its scope of application may differ between jurisdictions. For example, in Germany, automatic subordination applies to shareholder loans<sup>185</sup> while, in Spain,<sup>186</sup> it applies to all intra-group loans. Thus, even when an intra-group funding arrangement involves only countries that have subordination provisions, there is scope for ample disruption of a group’s basic operations: liabilities against an Italian bank might not be

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<sup>185</sup> Section § 39 (1) 4°-5°, and (4) (5) German Insolvency Act.

<sup>186</sup> Article 92 5° Spanish Insolvency Act.



subordinated, liabilities against a German bank would be subordinated only if held by the parent company, while liabilities against a Spanish bank would most likely be subordinated in any case. The potential disruption of basic operations would be even greater if some entities were located in countries that do not have subordination provisions but whose laws may give rise to equitable subordination, e.g. the United States.<sup>187</sup>

In addition to the diversity of approaches to statutory subordination, there is at least one more element of uncertainty. Since statutory subordination provisions worsen the treatment of debt, parties tend to circumvent them. In response, courts tend to react by applying a substance-over-form analysis, which means that the actual scope of the rules is not clear. This may affect the determination of the “equity replacing” nature of the loan or the determination of who is a “shareholder”.<sup>188</sup> In Germany, a substance-over-form analysis results in a *de facto* extension of the scope of the provision to loans by group entities controlled by the same shareholder<sup>189</sup> (making the scope of statutory subordination similar to the one in Spain) as well as to loans made by shareholders that later transfer their holdings<sup>190</sup> and to the assignee of the shareholder loan.<sup>191</sup>

In the *Goldman Sachs v Novo Banco* case discussed above,<sup>192</sup> BdP (the resolution authority) had indicated in a first decision (the “August decision”) that liabilities incurred towards persons who were also shareholders of the entity above a 2% threshold would be left behind<sup>193</sup> based on provisions applicable to loans by shareholders and related parties similar to those in Germany or Spain.<sup>194</sup> The reason why the

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<sup>187</sup> See Part I, section III.B.1.

<sup>188</sup> German courts applied a substance-over-form analysis in the past, which makes

<sup>189</sup> BGH 21.2.2013 IX ZR 32/12; BGH 18.7.2013 IX ZR 219/11.

<sup>190</sup> BGH 15.11.2011 II ZR 6/11.

<sup>191</sup> BGH 21.2.2013 IX ZR 32/12.

<sup>192</sup> *Goldman Sachs v Novo Banco*, [2015] EWHC 2371 (Comm). See section II.B.

<sup>193</sup> See *Goldman Sachs v Novo Banco*, [2015] EWHC 2371 (Comm) at 54.

<sup>194</sup> Article 145-H (2) of the Title VIII of the Legal Framework of Credit Institutions and Financial Companies Decree-Law No. 298/92, of 31 December 1992, inserted and approved under Decree-Law 31- A/2012 of 10 February 2012 (“the Banking Law”) read as follows: For the following cases, no obligations of the original credit institution may be transferred to the bridge bank: (a) The respective shareholders, whose participation at the time of the transfer is equal or greater than 2% of the share capital, the persons or entities in the two years prior to the transfer, have had interest equal to or greater than 2% of the capital, members of the board of directors or supervisory, the statutory auditors or

specific loan facility subscribed by Oak Finance was excluded in the later decision (the “December decision”) was that, in reality, the facility had been subscribed by Oak Finance Luxembourg on behalf of Goldman Sachs, which was a shareholder of BES, the resolution entity.<sup>195</sup>

This can have a dramatic impact on different types of bank funding beyond intra-group loans. First, if intra-group deposits are characterized as a loan from the depositor to the depositing entity, they would be subordinated. This may disrupt an intra-group funding structure, where different entities may keep deposits with each other, since one deposit could be treated as an ordinary claim in some countries, a subordinated claim in others (e.g. Spain) and a privileged claim in others (e.g. Italy, if deposit preferences apply without any distinction between deposits).

Second, hedging agreements, such as derivatives, should be excluded in cases where insolvency laws refer to “loans”, unless they are seen as an indirect means of funding one of the group entities, in which case the resulting liability could be subordinated not only in countries with statutory subordination rules, but also in those with equitable subordination. The problem would persist, however, in countries, like Spain, which subordinate all related party “claims.”<sup>196</sup> The fact that Spain dispenses privileged treatment to claims resulting from derivative agreements under certain circumstances<sup>197</sup> only makes the contrast more dangerous. If, say, a transaction involves a hedging agreement between a Spanish bank and a US bank (outside the group), but the agreement is backed by another agreement between the US entity and a UK bank that is part of the same group as the Spanish bank, the agreement could be recharacterized in Spain and subordinated, while the US entity would remain committed to paying the UK bank.

The solution could be to rely on collateralized transactions for funding, liquidity and hedging purposes.<sup>198</sup> However, this raises a third

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audit firms or people with similar status in other companies in controlling relationship or group with the institution; <sup>[1]</sup><sub>[SEP]</sub>

<sup>195</sup> Goldman Sachs held a 1,60% in shares, and a remaining percentage in derivatives positions. The interpretation of those positions as qualifying to establish Goldman Sachs’ interest as a shareholder was also controversial. See *Goldman Sachs v Novo Banco*, [2015] EWHC 2371 (Comm) at 57.

<sup>196</sup> Article 92 5º Spanish Insolvency Act.

<sup>197</sup> If the event of default that prompts the early termination of derivatives contracts occurs after the defaulting counterparty has filed for insolvency, any claim arising from those contracts will have priority over ordinary creditors in insolvency. For a detailed analysis of this privileged treatment, see Part I, section III.A.3.

<sup>198</sup> In the EU, entities would try to rely on articles 23 and 25 of the Winding-Up Directive, as well as on the Financial Collateral Directive. See Part I, section III.A.2.

problem, where the risk of subordination is compounded by the risk of avoidance<sup>199</sup> and recharacterization, or the risk of an interpretation that upsets the whole arrangement. In the *Lehman Brothers (Extended Liens)* case discussed earlier,<sup>200</sup> a custody agreement over securities was considered to fall outside the scope of protective provisions on Financial Collateral Arrangements because the collateral taker lacked “control” over the securities collateral. Instead, the court found that the security was a floating charge, which enjoyed less protection in the circumstances of the case. Importantly for our purposes, one of the key facts was that the clause was copied from a client custody agreement and pasted in an *intra-group* agreement for the management of cash and instruments.<sup>201</sup> Thus, even if the court did not use an anti-avoidance approach, and even if it ended classifying the arrangement within an existing type of security, the end result did not probably fit the group’s needs. Imagine a cross-border group setting where the entity entrusted with the group’s treasury is granted a security interest to carry out that role. That security interest is likely to be a floating security, which is only recognized in some jurisdictions and receives a different insolvency treatment in each. This may give rise to serious problems of enforceability and, in a resolution context, it may cast doubt over the application of bail-in to the secured liabilities.

The fourth problem may arise with “financial”, i.e. not “operational” debt, if this is issued by a banking entity and acquired in large amounts by other group entities. If this is “internal TLAC” debt, the *ex post* crisis management will fit with the *ex ante* planning. The problem may arise if ordinary senior debt subordinated by statutory provisions ends up ranking *pari passu* with internal TLAC that is subordinated (or non-preferred) by design. Admittedly, if both kinds of debt are held by the same entity, the problem may be one of increased transaction costs and not one of disruption of critical functions, but it may upset plans and undermine trust and confidence in authorities’ ability to accurately devise resolution plans. The problem may be more serious if “internal TLAC” debt and ordinary debt are held by different group entities, e.g. if a German or Spanish bank’s internal TLAC is held by its parent, but part of its ordinary debt is held by another entity in a different jurisdiction,

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<sup>199</sup> E.g. article 2497 *et seq* of the Italian Civil code, which punish the ‘inducement’ of a parent to a subsidiary to enter into a transaction not in the best interest of that subsidiary.

<sup>200</sup> *In the matter of Lehman Brothers International Europe*, [2012] EWHC 2997 (Ch). *Supra* 5.2.2. See also *supra* 3.1.2.

<sup>201</sup> The clause is reproduced in *In the matter of Lehman Brothers International Europe*, [2012] EWHC 2997 (Ch) at 32.

e.g. a US group entity. That ordinary debt could be bailed-in *pari passu* with internal TLAC, streaming losses in a way that would not figure in the group plans, is harming the interest of a different entity.

Even in a regional setting there are few provisions to deal with these problems. In the EU, BRRD provisions that exclude short-term liabilities from bail-in make an exception for intra-group debt,<sup>202</sup> which would not only be included in bail-in but have subordinated status. The BRRD also requires Member States to remove all impediments to intra-group financial support transactions,<sup>203</sup> but it does not look like this mandate is “actionable”, i.e. it does not seem that one may base a claim of invalidity against statutory subordination rules on this provision alone. An interesting question is whether this provision could justify an interpretation of domestic provisions on statutory subordination of intra-group liabilities that would leave out certain liabilities critical for operational reasons if a strict application of those rules would result in such an inconsistent treatment of intra-group transactions that would hinder any attempts to execute an intra-group support agreement. Such an interpretation seems unlikely, particularly in a context where intra-group support agreements are conceived for purposes of financing in times of crisis rather than day-to-day operational financing.<sup>204</sup>

In a global stage, the treatment of intra-group debt by certain jurisdictions would be a source of friction with others. It is not difficult to conceive of the application of subordination provisions by German, Spanish, Italian or Portuguese authorities as an action susceptible to non-recognition by authorities in, say, the United States, even under a principles-based system like the UNCITRAL Model Law on Cross-Border Insolvency, which include a public policy exception and a rule to protect domestic creditors.<sup>205</sup> In a discretion-based system like bank resolution, this would be even more likely.<sup>206</sup>

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<sup>202</sup> Article 44 (2) (e) BRRD excludes from bail-in ‘liabilities to institutions, excluding entities that are part of the same group, with an original maturity of less than seven days’.

<sup>203</sup> Article 19 (4) BRRD states that: ‘Member States shall remove any legal impediment in national law to intra-group financial support transactions that are undertaken in accordance with this Chapter, provided that nothing in this Chapter shall prevent Member States from imposing limitations on intra-group transactions in connection with national laws exercising the options provided for in Regulation (EU) No 575/2013, transposing Directive 2013/36/EU or requiring the separation of parts of a group or activities carried on within a group for reasons of financial stability.’

<sup>204</sup> See Part I, section IV.B.2.

<sup>205</sup> Articles 6 (public policy exception to recognition) and 22 (protection of domestic creditors) UNCITRAL Model Law on Cross-Border Insolvency. They have been applied in some cases that do not resemble the cases at hand, however.. See e.g. In Ackers v.

Since the substance of the provisions provides little consolation, the remedy may be in the procedure if it is robust enough to facilitate cooperation. A coordinated procedure should be easier in more integrated regional areas. Within the Eurozone, this is accomplished through partly centralising decision-making in a single authority, the SRB,<sup>207</sup> including the decision over the recognition of third-country resolution proceedings.<sup>208</sup> Yet even such centralisation is implemented within a cooperative structure, where consultation is a key element,<sup>209</sup> and the SRB instruct, and national authorities execute.<sup>210</sup> In the EU, the resolution *college* is the preferred solution to facilitate common solutions.<sup>211</sup> Once the college decides on a “group resolution scheme”, resolution authorities must implement the decision if they did not explicitly disagree with it.<sup>212</sup> However, resolution authorities can object and depart from the “group resolution scheme.”<sup>213</sup> The system is structured on a “justificatory” basis, i.e. authorities have discretion, but disagreeing authorities have to explain their reasons for departing from the resolution scheme.<sup>214</sup> This ensures that decisions are perceived as

Saad Investments Company Limited; in the matter of Saad Investments Company Limited (in official liquidation) [2013] FCA 738; In re Qimonda (Jaffe v. Samsung Electronics Co., Ltd.) 737 F.3d 14 (2013), CLOUT case no. 1212.

<sup>206</sup> In *re Sivec SRL*, US courts refused to grant recognition to a request to lift a set-off right in favour of a US creditor, because that creditor would have subordinated status in Italian proceedings, under a ‘comity’ framework, which is more discretionary than the UNCITRAL Model Law. See In re Sivec SRL No. 11-80799 476 B.R. 310 (2012).

<sup>207</sup> Article 42 SRMR.

<sup>208</sup> Article 33 SRMR.

<sup>209</sup> Article 31-32 SRMR.

<sup>210</sup> See, e.g. article 28 SRMR, on the monitoring by the SRB of the execution of the resolution scheme, and article 21, on bail-in powers.

<sup>211</sup> Article 88 BRRD.

<sup>212</sup> Articles 91 (6) (parent undertaking) and (10) (subsidiaries), as well as 92 (5) BRRD.

<sup>213</sup> Article 92 (4) BRRD.

<sup>214</sup> Article 92 (4) BRRD states that: ‘If any resolution authority disagrees with or departs from the group resolution scheme proposed by the group-level resolution authority or considers that it needs to take independent resolution actions or measures other than those proposed in the scheme in relation to an institution or entity referred to in point (b), (c) or (d) of Article 1(1) for reasons of financial stability, it shall set out in detail the reasons for the disagreement or the reasons to depart from the group resolution scheme, notify the group-level resolution authority and the other resolution authorities that are covered by the group resolution scheme of the reasons and inform them about the actions or measures it intends to take. When setting out the reasons for its disagreement, that resolution authority shall give consideration to the resolution plans as referred to in Article 13, the potential impact on financial stability in the Member States concerned as well as the potential effect of the actions or measures on other parts of the group.’

legitimate.<sup>215</sup> Underpinning this cooperative procedure is a strong framework of mutual (and automatic) recognition and a single jurisdictional system of review, which guarantees the system's robustness more than anything.<sup>216</sup>

Conversely, on a global scale, procedures need to fill the gap left by the absence of legal principles of mutual recognition (which are present, however, in cross-border insolvency) and a discretion-based, not law-based, coordination system. In this context, crisis-management groups (CMGs) and institution-specific Cooperation Agreements (CoAGs)<sup>217</sup> remain non-binding and untested, and focused on information exchange.<sup>218</sup> It is unclear how these structures would work under pressure or how they would address the problem of the uneven treatment of intra-group debt on a cross-border basis. In our view, they lack the tools and the incentives to make the major concessions that would be necessary to ensure a uniform treatment of debt that preserves critical functions *if* the bank has a minimally complex intra-group debt structure.

### B. *Cross-border groups and ex-ante planning: the balkanization of banking*

Given that large cross-border financial groups constitute the most major cause of concern for resolution frameworks, the lack of certainty about how the most elementary aspects of these frameworks would work is worrying. Resolution frameworks based on strong local authorities with broad mandate and discretion undermine any attempt to achieve cooperation based on legal principles.

Legislatures have decided to pull back. Instead of developing more detailed frameworks for cross-border situations, they have deployed *ex ante* planning rules that disincentivize (if not prohibit) “international” banking groups to the benefit of “multinational” groups.<sup>219</sup> In the US, this has been accomplished through rules that force “foreign banking organizations with total consolidated assets of \$50 billion or more and combined U.S. assets of \$10 billion or more” to consolidate them in an

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<sup>215</sup> See Part I, section II.C.

<sup>216</sup> This is why, when focusing on regional perspectives, we focused on this aspect. See section II.

<sup>217</sup> FSB Key Attributes no. 8.1 and 9. See section II.C.

<sup>218</sup> See section II.C.

<sup>219</sup> For the different models of international banking, see Part I, section II.A.

Intermediate Holding Company (IHC).<sup>220</sup> In the event of resolution, this IHC will be subject to receivership, or if systemically important, to the orderly liquidation authority (OLA),<sup>221</sup> which would simplify the task. Due to the decisive choice of a Single-Point-of-Entry strategy,<sup>222</sup> US resolution authorities can anticipate an upstreaming of losses to the IHC, followed by bail-in.

EU legislative authorities are responding in kind with newly proposed rules that require banks located in third countries with assets in the EU beyond a certain size (EUR 30 billion) to consolidate their holdings through an operating bank, or an IHC.<sup>223</sup> These banks should hold all their assets within the EU area and be subject to the corresponding licensing requirements, depending on whether they are a bank or a holding company.<sup>224</sup> This constitutes an important modification to the prior regime, which was based on the assessment of equivalence of the third-country's consolidated supervision and the establishment of an IHC was a measure contemplated for cases of non-equivalence.<sup>225</sup> Although the reforms are presented as an improvement on resolvability, they are seen as retaliation<sup>226</sup> for US measures, and they are likely to have a major impact on UK banks after Brexit.

The measures differ in their respective thresholds used in determining the obligation to establish an IHC and in their flexibility: for example, EU rules also permit consolidation under a banking institution. Yet both types of measures have a similar nature: they try to ensure that all the companies held in the US, or the EU, are consolidated with a common IHC. Thus, a foreign bank, even one that has to set up an IHC, could still carry on banking activities independently through bank *branches*.<sup>227</sup> This was the subject of the main objection by the ECB in its

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<sup>220</sup> 12 USC 5365; Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240 (March 27, 2014).

<sup>221</sup> See Part I, section II.B.

<sup>222</sup> See Part I, section IV.B.1.

<sup>223</sup> **Proposal for a Directive amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures** COM/2016/0854 final - 2016/0364 (COD) (hereafter, IHC proposal).

<sup>224</sup> Article 21b of CRD, as it would be modified by the IHC proposal.

<sup>225</sup> Article 127 (3) CRD.

<sup>226</sup> "EU to retaliate against US bank capital rules" *Financial Times* November 21, 2016.

<sup>227</sup> The Fed prudential rules state that "A foreign banking organization would have been permitted to continue to operate in the United States through branches and agencies subject to the enhanced prudential standards included in the proposal for U.S. branches

opinion regarding the proposed reforms, which suggested that foreign banks fulfilling the requirements in terms of asset size should consolidate all activities, including those carried on through a branch, in the IHC.<sup>228</sup> Indeed, initial evidence suggests that, at least in the US, where the measures are in place, foreign banks are shifting their assets to foreign and US bank branches.<sup>229</sup>

This has clear implications from a crisis-management perspective, since cross-border resolution would, in practice, be formed by several regimes, which could apply simultaneously: one for bank debt, where recognition of bail-in action would be subject to discretionary forbearance by local resolution authorities; another for bank branches, over which local resolution authorities would be competent, subject to limited coordination duties; and a third one for IHCs, where local resolution authorities would be fully competent. Imagine a large Eurozone bank with (i) TLAC debt issued by its EU parent company, which has also subscribed loan facilities all held in part by US investors and creditors, (ii) a branch in the US, and (iii) an IHC to consolidate its US and non-US subsidiaries, were to enter resolution. The requirements for the three different cases could apply separately. Although coordination would be made easier if both the FDIC and the SRB were, respectively, the competent authorities in the three cases, it is far from clear that they could operate smoothly enough to work out a solution, and tensions on one aspect (e.g. the treatment of US holders of the EU parent company's debt) could interfere with another (e.g. the treatment of bank branch assets and the transfer of resources to creditors in the EU).

Even if the authorities were to behave responsibly, in order to maximize the value on a global scale, existing planning rules clearly

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and agencies of foreign Banks.' The proposed article 23b (1) states that 'Member States shall require that *two or more institutions in the Union*, which are part of the same third country group, have an intermediate EU parent undertaking that is established in the Union.' (Emphasis added.).

<sup>228</sup> In its opinion, the ECB stated that: 'the requirement should apply to both third-country credit institutions and branches (i.e. also in cases where the Union operations of the third-country group carried out, partially or exclusively, via branches). Second, once an intermediate EU parent undertaking is established, it should be a requirement that the existing branches of the same third-country banking group exceeding a certain threshold are re-established as branches of a credit institution authorised in the Union to prevent regulatory arbitrage opportunities, since supervision of third country branches is not harmonised'. See Opinion of the European Central Bank of 8 November 2017 on amendments to the Union framework for capital requirements of credit institutions and investment firms (CON/2017/46) (2018/C 34/05) at 1.7.

<sup>229</sup> Lawrence Kreicher; Robert N McCauley "The new US intermediate holding companies: reducing or shifting assets?" BIS Quarterly Review (March 2018) p. 10.



pursue an agenda of insulating bank activities on a national, or regional, basis. The post-crisis concern may have been that global banks relied too much on wholesale markets to fund local activities, which resulted in more volatility.<sup>230</sup> However, that is different from saying that those same banking groups left their foreign operations less capitalized than their local ones, something over which there is no clear evidence. It also obscures the fact that the current rules that foster multi-national, rather than global, banks, with self-sufficient local activities, make it more difficult to reallocate resources to the places that may offer greater investment opportunities. Before this decisive step was taken, more evidence would have been desirable about the potential collateral damage, in terms of opportunities lost.

#### V. CONCLUSION: THE TREND TOWARDS LARGE, LOCAL, INTERVENED LIQUIDITY ISLANDS

We began our analysis of the frictions between insolvency law and bank resolution recalling an old paradox: What happens when an unstoppable force (a new resolution framework that will prevent the next financial crisis) meets an immovable object (a standard of fairness that is reflected in insolvency law)?<sup>231</sup> of collision between forces and objects of incommensurable strength. Our initial message was that the noise of the collision should not take our attention away from other processes that, in the shadow of the big, more salient struggle between bank resolution and insolvency ranking and priorities, could re-shape the face of banking in a more decisive manner. Having reached this point, we can gather some conclusions.

The first conclusion confirms our initial intuition: banking reform depends on discourse. The arguments and conversations in policymaking circles can change, and are indeed changing, the face of banking. This discourse is shaped by an argument about the collision between ending too-big-to-fail and protecting legitimate expectations. The major priority of bank reform is the need for harmony between financial stability, avoidance of contagion, and protection of taxpayers, which are the goals that shape bank resolution; and fairness towards creditors and protection of pre-existing commitments, which are the needs that shape insolvency.

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<sup>230</sup> Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240 (March 27, 2014) at 17,264.

<sup>231</sup> See Part I, section I.

However, behind this argument, a series of parallel conversations about the measures that could help achieve harmony and coordination between those seemingly colliding goals is taking place, often less noticeably. In our view, those parallel conversations have an even greater potential to change the face of banking. Yet, as in the children's game "telephone," where a message is whispered from one player to another, some may be surprised (though not amused) as the final version of the message is delivered to the expectant crowd. As a blunt summary, the rules promote a system of large, domestic banks that function as ring-fenced liquidity pools, while keeping a tight relationship with public authorities. To operate this shift, other things are changing in the process, sometimes dramatically, and not always in a good way. To understand how and why, we have used an analytical framework that considers the different dimensions of the problem sequentially: the basic problem, and its "external" and "intra-group" dimension; the dimension of the relationship between *ex ante* preventive rules, and *ex post* crisis-management rules; and the dimension of the domestic v. cross-border context.

We began our analysis with a simple dichotomy: banks are too complex, and any crisis management tools need to be deployed quickly to avoid contagion, preserve critical functions to avoid collapse, and write down equity and liabilities (bail-in) to avoid taxpayer losses, while simultaneously respecting basic notions of fairness instilled in the rules that determine creditor hierarchy in insolvency. Jurisdictions that have adopted frameworks to deal with bank crises have chosen different levels of interference upon, and coordination with, insolvency rules. The ones with the more intrusive stance, such as the US, the EU and Switzerland, face a problem of conflicting policies, which translates into a friction at the level of interpretative principles. These frictions can arise every time the status of a liability for bail-in purposes is called into question.

In this setting, concepts such as "deposit", "secured obligation", or "client money" can be a battleground of value-laden conceptions, each of which will tip the scales in favour of one policy goal, principle, or interest over another. In parallel, the interplay between resolution provisions that focus on "groups" and the rules for the subordination of related-party liabilities in some countries is uncertain. In such cases, whether the result is "the" correct one in substance can be as important as whether the decision is legitimate from a procedural and discursive perspective, which considers all relevant arguments, of policy and of principle. Still, even if the legitimacy of the process were to ensure robust decisions, a stable framework for the interplay between bank

resolution and insolvency ranking, and priorities were to emerge, this could take time, and the potential risks still could not be ruled out.

The second logical step of the conflict is to try to prevent the collision from happening in the first place. At the “external” level, banks are required to issue a new layer of debt that guarantees loss-absorbency (TLAC, or MREL in the EU) so that the uncomfortable questions about the bail-in of operational, or client-related, liabilities never arise. At an intra-group level, bank groups are required to have a suitable group structure and an adequate distribution of “internal” TLAC to ensure that losses are allocated to the entity that is eventually put into resolution, be it a single holding company (Single Point of Entry) or several entities within the group (Multiple Points of Entry).

This process, however, raises fundamental questions about the way the entities design TLAC or MREL debt, about the rights of clients that acquire that debt, and about the powers of public authorities. The new framework, especially in the US, favours a vertical organisation with a parent holding company, regardless of what is efficient for the group’s business model. In the EU, the rules benefit large groups, with access to international capital markets and institutional investors, while squeezing smaller competitors, regardless of what is good for society. All this is subject to rules whose open-texture seems to tolerate an unprecedented level of public interference in banking groups’ structures and strategic decisions, which stakes all limits and safeguards to a principles-based interpretation, to effect a court review based on the rationality of the authorities’ justification, the appropriateness of the measures, and their proportionality.

The more dramatic changes, however, are operated when we consider the domestic versus cross-border dimension of the problem. Resolution is justified by the need to have specific tools that protect certain interests better than insolvency tools do. Yet this logic is flawed when transferred to a cross-border setting because the alternative to a robust yet suboptimal framework for cross-border insolvency is a patchwork quilt of non-binding agreements between authorities, private sector solutions and good faith, where resolution authorities enjoy broad and unilateral discretion. All these elements undermine the robustness of this alternative framework. Far from being deluded into a false sense of security, legislatures have deepened into territorialist solutions to protect “their” savers, e.g. by protecting local deposits. The fact that territorialism is the default principle does not bode well for the cross-border enforcement of insolvency priorities in other cases, e.g. trying to exclude liabilities subject to bespoke security arrangements from bail-in, the cross-border recognition of insolvency ranking, or situations where

there may be offerings of subordinated or non-preferred debt subject to the laws of different jurisdictions. Territorialism is a slippery slope, and the awareness of the risk of non-recognition and lack of coordination has led legislatures to deploy *ex ante* measures that try to prevent the problem by requiring large institutions to hold assets located in the relevant jurisdiction within intermediate holding companies (IHCs). By being subject to prudential requirements, these IHCs are turned into liquidity pools, or, more accurately, liquidity islands. Applying the so-called “international trilemma” to our analysis, it becomes clear that, instead of diluting the powers of domestic resolution authorities through a strong coordination framework, lawmakers have strengthened those powers. This risks *global* financial stability to the benefit of *local* financial stability. In the trilemma of national authorities, global financial stability and global banks, the latter are being sacrificed.

A system that was conceived to end “too-big-to-fail” is on course to achieving its goal, but through an unexpected path. This path is changing the face of banking in ways that may not have been anticipated, and which may not necessarily be for the better. Put shortly, resolution frameworks were created to avoid Lehman-like bankruptcies. Years later, a formidable edifice is in place, but one that cannot deal with a Lehman-like bankruptcy. Instead, the rules try to end Lehman-like banks, which may be good, but they do so by taking steps that may be more questionable. Banking groups are becoming easier to dispose of, insolvency systems of ranking and priorities less relevant, and greater ring-fencing of resources will hinder capital mobility.

In addition, banks now need to place large amounts of debt in the market, which, for smaller banks (at least in Europe) means a choice between placing it among their clients (risking investor protection) or increasing their size to reach international capital markets and institutional investors. Larger banks will be more co-dependent with the State, especially since it is intervention by public authorities that determines their funding needs and corporate structure. The relationship between banks and State will be further strengthened by the territorialist choices made in the cross-border context. Having strong resolution authorities with ample powers makes sense in a domestic setting. In a global setting, it makes rules-based and principles-based cooperation more difficult, which endangers global stability, unless global banks give way to multi-national banks.

These trade-offs are not straightforward and should be the subject of debate. That debate is not happening because the problem is too complex, has too many ramifications, and each of them is part of a separate conversation. In this two-part article, we have presented an

analytical framework that considers those ramifications sequentially as different dimensions of the problem that pile upon each other. By picking those dimensions apart and analysing them separately, the choices will not be easier, but at least they will be clearer. It is our hope that a better, more robust resolution framework will be the outcome.