U.S. BANKRUPTCY BILL MAY FIX PROBLEM FOR U.S. STATE ADMINISTRATION OF ASSETS OF BRANCHES AND AGENCIES OF INSOLVENT FOREIGN BANKS

Two very different methodologies for international bank supervision grew out of the Bank of Credit and Commerce International failure several years ago; one is now back on center stage due to pending litigation in New York. One methodology is consolidated, worldwide supervision by home countries of their international banks. The other is "ring fencing," a procedure for dealing with branches and agencies of insolvent international banks in host countries whereby the local supervisor seizes and administers the local assets, with a preference for local creditors, in a liquidation that is separated from the liquidation of the bank as a whole. This procedure has become the international norm for multijurisdiction bank insolvencies.[1] Ring fencing allows local investors to view an international bank as protected, at least in their country, by a credible supervisor they know, free from the effects of negligence, politics or corruption in the home country -- a significant advantage for branches and agencies of international banks, particularly for those from emerging countries. Now ring fencing by U.S. state bank supervisors is threatened by a case on appeal in the Second Circuit Court of Appeals in New York.

The Problem

The Agency for Deposit Insurance, Rehabilitation, Bankruptcy and Liquidation of Banks (the "Agency") in Yugoslavia petitioned the U.S. Bankruptcy Court to compel the New York Superintendent of Banks (the "Superintendent") to turn over to the Agency the assets of the New York agencies of two insolvent Yugoslavian banks. The Bankruptcy Court dismissed the Agency's petition on the ground that a foreign bank cannot be a "debtor" under the Bankruptcy Code. In *Agency for Deposit Insurance v. Superintendent of Banks*, Judge Jed S. Rakoff reversed the decision of the Bankruptcy Court, holding that section 304 of the Bankruptcy Code did not require the Agency to be a "debtor" to obtain the relief sought against the Superintendent, and remanded the case for a determination as to whether the Agency was entitled to that relief. The Superintendent moved for reconsideration or a certification of the order for immediate appeal and Judge Rakoff denied the motion.[2] The Second Circuit will soon be deciding whether to accept the Superintendent's appeal of Judge Rakoff's decision.

The case is significant for current procedures with respect to winding up the affairs of state-licensed branches and agencies of foreign banks. If Judge Rakoff's decision is upheld, state banking supervisors will no longer be assured that they can seize the assets of the branches and agencies of foreign banks they supervise in order to administer the liquidation of those branches and agencies locally. Ring fencing procedures for state banking supervisors are authorized by

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[1] Inasmuch as branches and agencies of foreign banks generally are treated as separate entities for purposes of host country (but not home country) supervision, the procedure is not as odd as it may seem.

[2] No. 03 Civ. 9320, 2004 U.S. Dist. LEXIS 10848 and 15910 (S.D.N.Y. June 14 and August 13, 2004).

state laws, but state laws can be trumped by federal law, including the Bankruptcy Code. So, the Rakoff decision threatens to disrupt customary state supervisory practices, or even bring down all of the foreign bank insolvency processes in the states. State bank supervisors and others in the banking industry have stressed the grave consequences of upholding Judge Rakoff's decision, but that decision squares with established precedent and the prospect of reversal on appeal is not encouraging. If Judge Rakoff's decision is not reversed on appeal, the Bankruptcy Court nonetheless maintains a fair amount of discretion in deciding whether or not to grant the relief sought by the Agency, as such relief is within the scope and purpose of section 304.

The Bankruptcy Code

Section 304 of the Bankruptcy Code permits a "foreign representative" to file a petition with the Bankruptcy Court to initiate a "case ancillary to a foreign proceeding," that is, among other things, to seek an order of the Bankruptcy Court transferring property in the United States that is part of the bankruptcy estate in the foreign proceeding to the foreign representative. A "foreign representative" is defined in the Bankruptcy Code as a duly selected trustee, administrator or similar officer of a bankruptcy estate in a foreign proceeding. The courts have concluded that neither the "foreign representative" nor the bankrupt person that is the subject of the foreign proceeding need be a "debtor" that otherwise would be eligible for relief in a primary proceeding filed under the Bankruptcy Code (*e.g.*, under chapter 7 or 11).[3]

The purpose of section 304 is to enable a foreign bankrupt person "to prevent the piecemeal distribution of assets in the United States by means of legal proceedings initiated in domestic courts by local creditors."[4] The policies behind ring fencing and those behind section 304 are opposed, and it is therefore not surprising that *Agency for Deposit Insurance v. Superintendent of Banks* is causing consternation among state bank supervisors as well as within the Federal Reserve Bank of New York.

The Bankruptcy Bill

Congress is now considering H.R. 685 and S. 256, which, if passed, will constitute the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. (The bills are virtually the same.) Title VIII is intended, among other things, to fix the problem posed by *Agency for*

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3 *In re Goerg*, 844 F.2d 1562 (11th Cir.), *cert. denied*, 488 U.S. 1034 (1989). One argument of the Superintendent in *Agency for Deposit Insurance v. Superintendent of Banks* is that, because the Yugoslavian banks are excluded from the definition of "debtor" in the Bankruptcy Code, the Agency cannot obtain relief under section 304. But, as noted, the courts have "held squarely" that the debtor eligibility requirements of section 109 are not "grafted onto section 304." *See, e.g., In re Brierley*, 145 B.R. 151 (Bankr. S.D.N.Y. 1992).

4 *In re Koreag, Controle et Revision, S.A.*, 961 F.2d 341 (2d Cir.), *cert. denied*, 506 U.S. 865 (1992). The legislative history (S. Rep. 95-989, 95th Cong., 2d Sess. 35 (1978)) is helpful:

> [W]here a foreign bankruptcy case is pending concerning a particular debtor and that debtor has assets in this country, the foreign representative may file a petition under [section 304], which does not commence a full bankruptcy case, in order to administer assets located in this country, to prevent dismemberment by local creditors of assets located here. …

Deposit Insurance v. Superintendent of Banks. Section 802(d)(3) will eliminate section 304. Section 801 will introduce a new chapter 15 into the Bankruptcy Code to deal with cross-border bankruptcy situations; this new chapter will codify and modify the judicial decisions stemming from section 304. Our concern is whether this new chapter, like section 304, will thwart ring fencing by state bank supervisors when foreign banks become insolvent.

The answer is no.

Section 1501(c) of the new chapter will provide that the chapter does not apply to a proceeding "concerning an entity, other than a foreign insurance company, identified by exclusion in section 109(b)." Section 109(b) (in relevant part) excludes from the class of persons who can become "debtors" under the Bankruptcy Code foreign banks with U.S. branches or agencies, as well as foreign savings banks, cooperative banks, savings and loan associations, building and loan associations, homestead associations and credit unions with branches and agencies in the United States. Thus, if the bills become law, the administrator in an insolvency proceeding of a Yugoslavian bank in Yugoslavia, for example, will not have access to the Bankruptcy Courts in the United States to capture the assets of the U.S. branches and agencies of the Yugoslavian bank for administration in the Yugoslavian proceeding. With the passage of the pending U.S. bankruptcy bill, ring fencing and other related contractual wrap-up techniques authorized by state law will survive and will not face the prospect of being challenged as part of an ancillary proceeding under U.S. bankruptcy law.

The prospect for passage of the bankruptcy legislation remains uncertain, although passage of the bill seems more likely than in the past. However, efforts to pass comparable legislation during the past eight years have failed for a variety of reasons. In the current session of Congress, the U.S. Senate, which has been the more difficult chamber in which to obtain support for such legislation, is moving first and with some alacrity. The Senate Judiciary Committee passed S. 256 with a bipartisan 12-5 vote on February 17. The full Senate began vigorous debate on the bill on February 28, 2005 and consideration of the bill is expected to last for at least two weeks with potentially dozens of amendments being offered. Certain amendments, such as the one authored by Senator Schumer to prevent abortion protestors from avoiding financial penalties by filing for bankruptcy protection, are viewed as controversial and would significantly weaken the prospects for passage if included as part of the final bill. The House has yet to act in this session but last session it passed H.R. 975, with 89 cosponsors, with a vote of 315-113 on March 19, 2003. The bill has been reintroduced in the House as H.R. 685 with 75 cosponsors. It would appear that the House is waiting to see if the Senate passes the bill; indeed, the House may decide to pass the Senate version of the bill in order to circumvent any need for a conference committee and further legislative deliberation. President Bush already has suggested that he would sign the bill if it passes in Congress.

The bankruptcy bill should solve the problem for state administration of branches and agencies of insolvent foreign banks in the future. The law likely would not affect the pending case involving the Agency and the State of New York. So, it is possible that the Yugoslavian liquidators case might still be decided in a manner that is adverse to the Superintendent and the

final result could be contrary to the expectations of local creditors and other parties with derivatives contracts and similar agreements that were relying on the actions of the Superintendent to uphold their contractual positions.

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If you have questions about this memorandum, please contact Timothy McTaggart (202-303-1121, tmctaggart@willkie.com), John Cairns (212-728-8207, jcairns@willkie.com), Steven Wilamowsky (212-728-8499, swilamowsky@willkie.com) or the attorney with whom you regularly work. John Cairns and Timothy McTaggart are members of the firm's Financial Institutions Group and advise banks and other financial institutions and persons dealing with them. Steven Wilamowsky is a member of the firm's Business Reorganization and Restructuring Group which, among other things, has represented numerous entities involved in ancillary proceedings under the U.S. Bankruptcy Code.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is 212-728-8000, and our facsimile number is 212-728-8111. Our website is located at www.willkie.com.

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