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Mr Eral Knight
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Dear Eral

ISSUE 129: Proposed EU Regulation creating a European Account Preservation Order

As I am sure you are aware, the role of the Financial Markets Law Committee (the “FMLC”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

The FMLC notes and hereby responds to the Consultation Paper CP 14/2011 in respect of the Proposed EU Regulation creating a European Account Preservation Order to facilitate cross-border debt recovery in civil and commercial matters (the “Proposal”). It is not the role of the FMLC to question the policy underlying the Proposal. It is, however, the view of the FMLC that although there may be value in the introduction in the UK of a procedure which enables a creditor to obtain a European Account Preservation Order (an “EAPO”), the implementation of the Proposal, in its current form, may in the future raise some serious conceptual and practical issues for financial market participants and that it is in the interests of ensuring robust financial markets that these issues are recognised and addressed in a revised form of the Proposal.

The FMLC regards the principle of the initiative embodied in the Proposal as worthwhile. For this reason, the FMLC does not consider that it is imperative that the UK government should exercise its right to opt out, although as set out below, it does consider that there are a number of areas of uncertainty which may lead the UK government to conclude that it should do so, if it considers that it has insufficient comfort that the necessary amendments will be made to the Proposal. Although in the past the FMLC has expressed reservations about the broader proposals for harmonisation of European law (and in particular contract law),¹ in this instance, the FMLC believes that a case can be made for the introduction of a more or less standardised procedure for obtaining an EAPO, proper account being taken of necessary differences of detail between different member states of the European Union (each, a “Member State”).

Present Position

It is the FMLC’s view that the present position for parties involved in disputes in the sphere regarding which the Proposal seeks to legislate is unsatisfactory, especially from the point of view of creditors embarking upon litigation with cross-border implications. In such cases, whatever jurisdiction may be chosen, a claimant may face a defendant who resides in country A, has a business in countries B and C and has subsidiary interests in countries D, E and F. The defendant may have assets in all of these countries. At present, the legal position of all countries must be researched, and not only the procedure but the very nature of preservation orders and their

¹ See <http://www.fmlc.org/papers.html>.

availability may differ widely between them. Until now it has not even been possible for *ex parte* orders to be enforced in other Member States, and although the Brussels I Regulation² is being amended in this respect, there will remain uncertainties as to how far *ex parte* orders made in country X would actually be enforced in country Y without follow-up action in country Y.

In principle, the effect of an EAPO and the procedure leading to its issuance should be to enable concerned parties to avoid much of the difficulty posed by the present position and to enable the court with primary jurisdiction to make effective orders in all (to further the example given above) of countries A to F. Provided that an EAPO is properly and comprehensively drafted and the procedure relating thereto successfully implemented, an EAPO has the potential to reduce costs and complexity, not only for claimants, but also for recipients of orders (such as banks), who have to enforce so many different types of orders in so many different ways, as is the case at present.

Although the FMLC is of the view that, in principle there may be value in the introduction of an EAPO (if properly drafted and implemented in the UK) the FMLC has identified, and comments on below, some features of the Proposal which, if implemented, may introduce legal uncertainty.

Lack of Sufficient Protection for Defendants

The Proposal as drafted appears weighted towards claimants. Claimants are required only to complete a short application form and provide it to a court which is required to issue a decision within seven days. A hearing will take place in exceptional circumstances, but no indication is given as to what would constitute "exceptional". So long as a form is not defective on its face, the court appears to have no discretion as to whether or not to issue a decision.

In the FMLC's view, procedural fairness for both parties and the need for transparency and predictability in court decisions dictates that a hearing should take place in most, if not all, cases to ensure that the claimant's position is adequately tested. A further example of a lack of procedural safeguards is that the Proposal provides for an *ex parte* procedure: Unless the claimant requests otherwise, the defendant will not be notified of the application or be heard prior to the issue of the EAPO.

With respect to the burden on a claimant in connection with the granting of an EAPO, the test for deciding whether an EAPO should be granted is whether a subsequent judgment is likely to be impeded or made substantially more difficult without an EAPO. This does not appear to be a very high hurdle for a claimant to meet, if it will be sufficient to argue that the need to search for assets after enforcement will make enforcement more difficult than having assets frozen in advance.

By contrast, a defendant applying to challenge an order may be required to wait up to thirty days before a court will decide on its application. During that time period, the defendant's assets will remain frozen. Corporates shall be entitled to amounts necessary "to ensure the possibility to pursue a normal course of business" during this time, but it is unclear how such amounts would be determined and whether such amounts would actually be sufficient. As a result of this uncertainty, the defendant could face difficulty in planning for and ultimately fulfilling present and future legal obligations owed to third parties. In addition, such amounts would only be available if provided for under the law of the Member State of enforcement. Such amounts would be available under English law (as it currently stands), but defendants with assets elsewhere in the EU would be disadvantaged if this were not the case in the relevant Member State.

In the UK, there are protections for defendants faced with freezing orders, which are put in place as qualifications to an order of the English court when made and are discretionary. The Proposal does not provide for a stage at which those protections can be applied. This is largely because the Proposal provides that a hearing will only take place in exceptional circumstances, so it does not appear that there is an opportunity for the relevant court to make a decision to attach discretionary relief to an EAPO. Originating court protections are arguably disapplied by the Proposal, but would in any event be legally difficult to apply as in many countries the relevant court or administrative body would have no jurisdiction in respect of assets outside the relevant country.

² Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters

In light of the difficulties set out above, a change of English law to introduce statutory protections which would fit with the procedure set out in the Proposal may be required for a successful implementation of the Proposal in the UK. Alternatively, statutory protections should be authorised and recognised in a revised form of the Proposal. Otherwise, a challenge to the new UK legislation based on one or more of the EU's four freedoms (i.e. the free movement of goods, capital, services and people) might succeed as the new rules would be said to, for example, create disincentives to interstate trade. The FMLC does not interpret references in the Proposal to "national law" (as to which see further below) to mean that a Member State is free to introduce extensive new laws that might thwart the effectiveness of EAPOs.

Disadvantage to UK Creditors

In addition to the foreseeable disadvantages to defendants, the FMLC notes that the Proposal introduces a disadvantage to UK creditors of UK debtors *vis-à-vis* foreign (namely, EU) creditors of UK debtors. This is because under the Proposal, EAPOs will only be available in cross-border cases. A possible effect of this and disadvantage to UK creditors (which, in each case, the FMLC would think unintended), is that UK debtors will be presented with an incentive to pay off its foreign creditors ahead of its UK creditors in order to avoid the possibility of being faced with an EAPO.

Uncertainties as to Scope

There are several other areas of uncertainty in the Proposal that could impact the financial markets. One of these relates to the possible displacement of prior charges and negative pledges, as unlike current UK freezing orders, an EAPO would take effect *in rem* (i.e. similar to a fixed charge). Under the Proposal, the issue of priority seems to be a matter for national law, but it is not clear whether that would be of the enforcing Member State or otherwise and whether that Member State's conflict rules would apply. The FMLC is not aware of any clear precedents as to how the English courts would resolve issues of priority in a similar case or what rights the courts would accord an objecting third party, but it is possible that an EAPO would take precedence over the claims of the holder of a prior floating charge and would be unaffected by a negative pledge. That in itself has significant implications for secured lenders and for systems relying on floating charges over assets of participants which could be subject to an EAPO, but which would not be covered by exclusions under the systems. In addition, it appears that an EAPO granted before the insolvency of the defendant would remain unaffected and therefore accord the claimant effective priority over unsecured creditors in the event of a subsequent insolvency. On a related note, in the case of a large claim against a company, an EAPO might not only occasion an insolvency, but may also disrupt the process of administration by starving the company of working capital.

Another point of uncertainty arises from the fact that the Proposal does not expressly provide for set-off rights (which are automatically included within English freezing orders) in connection with EAPOs. On the contrary, Articles 21(6) and 26(1) prevent banks from transferring, disposing or withdrawing any funds from an account subject to an EAPO (and the Proposal does not contemplate any circumstances under which a third party financial institution may use or deal with the frozen funds). If it is intended that derivative transactions (which appear to fall within the definition of securities) will be covered by EAPOs, the absence of a right of set-off will introduce significant uncertainty with respect to rights of netting and credit support in connection with such transactions.

It is also unclear what would happen in the case of a frozen bank account that is part of a netting arrangement between a group of companies and the relevant bank. If that bank account had to be taken out of the netting arrangement, such a change would increase the cost of capital for the bank and could result in breaches by the customer group as a whole of its arrangements.

Under the Proposal, it appears that an EAPO could impact securities accounts, not just bank accounts. All the uncertainties related to the nature of rights in intermediated securities are thus brought into issue, as well as the need to ensure that mixed accounts holding the securities of more than one person either cannot be attached or that procedures to apply an EAPO to a new account containing securities to the value of only the defendant's interest in the pool are possible, so as to ensure that there is no unintended impact on third parties.

Another uncertainty to be addressed is how and to what extent a central bank, the operator of a monetary clearing system or a commodities clearing system would be protected if involved in an

EAPO procedure. Financial stability issues could arise if the effect of an EAPO were to block settlements in a system. Furthermore, if the Proposal were meant to or could capture exchange-traded derivative transactions credited to an account with a bank that also acts as an executing broker on a derivatives exchange or trading platform or as a clearing member of a recognised clearing house, then the FMLC is of the view that a detailed impact assessment should be carried out in order to ascertain and address the legal uncertainty and/or operational disruption issues that such an inclusion may cause.

Uncertainty also stems from the absence of money laundering requirements on the claimant and duties of confidentiality regarding a defendant's bank account details. There are no such requirements or duties on the part of the claimant, yet a bank is expected to take instructions from the claimant and release extensive confidential information to it. There is uncertainty as to how this information might be used.

Another specific example of uncertainty concerning information arises from Article 17. Article 17 of the Proposal provides that where a claimant does not provide (presumably because it does not know) the bank account details of the defendant, the claimant may request that the competent authority of the Member State of enforcement obtain the necessary information. Such Member State is then required to use "all appropriate and reasonable means available... to obtain the information." It is unclear what means would be seen as appropriate or reasonable. One of the methods contemplated is to ask all banks within a particular Member State to disclose whether the defendant holds an account with any of them. This seems to the FMLC unworkable both from the perspective of the relevant UK authorities but also from the perspective of UK banks with a presence throughout the EU.

In addition to the uncertainties outlined above, a number of definitions in the Proposal as drafted give rise to uncertainty in terms of what it is intended the Proposal will cover. For example, the Proposal is expressed to apply to "pecuniary claims" but it not clear whether that term would cover claims for damages. Similarly, it is not clear whether "bank" applies to all entities within a banking group or only those which are deposit-taking. The definitions of "bank account" and "financial instruments" similarly give rise to uncertainty; it is not clear whether they are, for example, intended to cover swap contracts. Additionally, the use of the term "financial instruments" imports uncertainty because it is defined by reference to Directive 2004/39/EC of the European Parliament and of the Council. With a few exceptions, over-the-counter derivative contracts fall within that incorporated definition, but it is not clear whether they are meant to be captured by the Proposal, as it seems that the obligations owed by a bank to its counterparty (i.e. the prospective defendant against whom an EAPO may be sought) under an OTC derivative contract (for example, under an ISDA master agreement) would not be characterised as being those in connection with "[an] account... held with a bank in the name of the defendant" and fall within the definition of "bank account" in the Proposal. This uncertainty could be addressed by limiting the term "financial instruments" to transferable securities and perhaps money-market instruments and units in collective investment undertakings.

Jurisdictional Uncertainties

There are a number of jurisdictional uncertainties about the Proposal which could lead to jurisdictional challenges and satellite litigation. In particular, while the claimant has the choice of forum in which to apply for an EAPO, the claimant's selection of a particular Member State's court may be disputed by the defendant if, for example, proceedings have been commenced in breach of an exclusive jurisdiction clause.

A further area of uncertainty in the Proposal arises from references therein to "national law". A defendant's right to challenge an order is subject to "national law", but it is not clear to which national law the relevant provisions refer. In addition, because a number of elements of the operation of an EAPO are left to national law, there may be differences between the ways in which two EAPOs issued by the same court will operate, even if issued on the same day for the benefit of the same claimant.

With respect to third parties, the Proposal only makes provision for a third party to raise objections against an EAPO to the extent that the relevant order or the enforcement of that EAPO prejudices the rights of that third party. The proposal provides that a third party has the right to raise objections before the courts of the Member State of origin or of enforcement, but it is not clear to which Member State's courts a bank or other third party should apply if that bank or other third party

seeks clarification as to whether certain assets or accounts are covered by the EAPO. If it is contemplated that a bank will need to apply to the court which issued the order, this will be a significant burden on the relevant bank. This is particularly the case in circumstances where costs will not be available in all circumstances and in any event there is no clear mechanism specified in the Proposal as to how any costs to which a bank may be entitled are to be recovered.

The FMLC would be very happy to discuss the above matters with you further and, where appropriate, to work with the Ministry of Justice to draft proposed wording to address the issues set out above.

Yours sincerely

A handwritten signature in black ink, appearing to read "Joanna Perkins".

Joanna Perkins
FMLC Director