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FINANCIAL MARKETS LAW COMMITTEE

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Discussion of certain legal uncertainties arising from the European Insolvency Regulation

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FINANCIAL MARKETS LAW COMMITTEE

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This addendum has been produced by the Financial Markets Law Committee (the "FMLC") Secretariat.[1] The FMLC is very grateful to Jennifer Marshall of Allen & Overy LLP and Mark Arnold, Barrister at South Square, for their assistance with this paper.

[1] Joanna Perkins (following her appointment as assistant to the UK Reporter to the study on the reform of the European Insolvency Regulation Joanna made no further substantive contribution to this paper) and Roland Susman.

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1. Introduction

1.1. The remit of the Financial Markets Law Committee (the "FMLC" or the "Committee"), established by the Bank of England, 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.

1.2. This paper highlights a number of core legal uncertainties arising from the European Insolvency Regulation (the "EUIR").[2] This paper is not intended to provide an exhaustive discussion of uncertainties which may arise from the EUIR. Further uncertainties, notably with regard to Article 5 of the Regulation, may be identifiable.

2. The exclusion of investment undertakings from the scope of the EUIR

2.1. Article 1(2) of the EUIR expressly excludes insurance undertakings, credit institutions and investment undertakings from the Regulation's scope. Insurance undertakings and credit institutions are, however, subject to their own sectoral Directives which provide for a Community insolvency framework in respect of their industries.[3]

2.2. In the view of the FMLC, the fact that investment firms and collective investment schemes do not fall within either a general or sectoral Community framework for insolvency proceedings represents a lacuna in European legislation which gives rise to legal uncertainty as to the treatment of these businesses on their insolvency.

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[2] Regulation (EC) No 1346/2000.

[3] Directives 2001/17/EC and 2001/24/EC respectively.

2.3. The FMLC, therefore, supports the recent proposal from the Commission to amend the credit institutions winding up Directive in order to bring investment firms within its scope.[4]

2.4. The Committee notes, however, that the Commission's proposal does not extend to collective investment schemes. It is the FMLC's view that legal certainty would be promoted by the amendment of European legislation in order to ensure that collective investment schemes also fall under a sectoral or Community wide framework for insolvency proceedings.

3. Choice of law

3.1. The general choice of law rule in the EUIR is found in Article 4. Article 4 provides that the law applicable to insolvency proceedings is the law of the state in which proceedings are opened (henceforth referred to as the "Insolvency Forum").

3.2. Articles 5 to 15 of the EUIR set out exceptions to this general rule. The FMLC believes that these exceptions are intended to protect the legitimate expectations of parties with respect to their rights over assets and to maintain the availability of credit. The Committee is given to understand that a considerable number of market participants consider that the Articles have proved important in achieving these aims.

3.3. The FMLC notes that the protection of legitimate expectations is consistent with legal certainty and that the assurance of the availability of credit may be of benefit to financial stability.

3.4. The FMLC believes, nevertheless, that the exceptions provided for by Article 5 (*Rights in Rem*), Article 6 (*Set-Off*) and Article 13 (*Detrimental Acts*) have,

[4] This proposed change can be found in the Commission's proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms, COM(2012) 280/3.

in practice, given rise to legal uncertainty; these uncertainties are discussed in paragraphs four, five and six below.

3.5. The Committee understands that Articles 5, 6 and 13 of the EUIR have, to date, been the subject of limited litigation. The FMLC acknowledges, therefore, that future jurisprudence of national courts and, ultimately, the European Court of Justice may provide further clarity with regard to the provisions. Notwithstanding this fact, the Committee emphasises that, in the absence of further litigation, legal professionals will find it difficult to provide clear and unambiguous advice to clients on these issues. The FMLC notes, moreover, that its aim is, where possible, to avoid the need for time-consuming and expensive litigation to address legal uncertainties.

4. Article 5 (*Rights in Rem*)

4.1. Article 5(1) of the EUIR is intended to protect the rights *in rem* of creditors from the effect of Article 4 where assets are located in a state other than the Insolvency Forum.[5] The FMLC believes that the Article gives rise to legal uncertainty for the reasons discussed in this paragraph.

4.2. <u>What constitutes a right *in rem*?</u>

4.2.1. The meaning of right *in rem* is uncertain. Some guidance is provided by Article 5(2) which sets out rights to which the term right *in rem*, for the purposes of Article 5(1), should "in particular" apply.[6] This inexhaustive list of examples, however, does not constitute a definition and right *in rem* is not defined elsewhere in the EUIR. The concept does not have a settled meaning; it is not a recognised term in European law and its usage tends to differ as between Member States.

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[5] It is noted that assets located in a Member State in which secondary proceedings have been commenced will not be protected by Article 5.

[6] Article 5(3) also provides some specific guidance: it states that a right, recorded in a public register and enforceable against third parties, under which a right *in rem* within the meaning of Article 5(1) may be obtained, shall be considered a right in rem.

Perhaps the most that one can say is that a right *in rem* is similar to a proprietary right.

4.2.2. Notwithstanding the broad consensus that a right *in rem* is, or is analogous to, a proprietary right, it remains unclear whether particular interests in financial instruments constitute rights *in rem*. This uncertainty may be clarified by the courts in due course. Nevertheless, in the interim, uncertainty about such instruments is likely to cause difficulty for participants in the financial markets. Rights and interests in the following instruments can be expected to cause problems, in particular: retention of title clauses, flawed asset arrangements, finance leases, sale and repurchase agreements and powers of attorney.

4.2.3. Powers of attorney, for example, are widely used in many contexts in the financial markets. Of particular concern to the FMLC are security powers of attorney which play a crucial role in settlement operations. This can best be illustrated in the context of the securities settlement system of the UK as described in Appendix I.

4.3. <u>What is the conflict rule for questions affecting rights *in rem*?</u>

Article 5 does not explicitly establish a conflict of laws rule for questions affecting rights *in rem*. One view common amongst legal practitioners is that the law applicable to such questions is the *lex situs* of the relevant asset. That Article 5 makes reference to the location of assets may beg this inference. The FMLC suggests, nevertheless, that an explicit statement of the conflicts rule would be a useful amendment: all things being equal, it does not, in the view of the FMLC, promote legal certainty for a conflicts rule to be founded on an inference.

4.4. <u>What is the *lex situs* of an intangible asset?</u>

4.4.1. Assuming—as inferred above—that the law applicable to questions affecting rights *in rem* is the *lex situs*, the question as to how to identify

an asset's location (or "*situs*") is an important one. The location of an intangible asset, such as a financial instrument, may be unclear.[7]

4.4.2. There is no consensus (certainly no international consensus) on the legal rules for identifying the location of an intangible asset. Not only do the rules for identifying the *situs* differ from jurisdiction to jurisdiction but, in some cases from instrument to instrument. Moreover, there is no consensus between expert commentators on the best rules to implement supra-nationally. One rule that obtains for convenience is that an intangible asset's location is the place of payment under the contract under which it is constituted.[8] Another view is that an intangible asset's location is the legal domicile, place of business or principal residence of the relevant debtor.[9] (Both rules are probably premised on the principle of efficacy which dictates that rights should be governed by the law of the place where they will be enforced.)

4.4.3. The EUIR does not set out which court is competent to decide an asset's location. Article 2(g), however, provides some guidance with respect to this question by setting out where, for the purposes of the EUIR, certain types of asset are located:

4.4.3.1. tangible property is located in the Member State within the territory of which the property is situated;

4.4.3.2. property and rights ownership of or entitlement to which must be entered in a public register are located in the Member State under the authority of which the register is kept; and

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[7] Of less relevance to the wholesale financial markets, but still of concern for some commercial arrangements, is the problem of moveable tangible assets. Identifying the *situs* of an asset that moves regularly across borders—for example a combine harvester, to take but one example oft cited by conflict of laws specialists—can, self evidently, be difficult.

[8] It is noted that the place of payment may not be set out in a contract which would necessitate a further rule to determine that location.

[9] See UNCITRAL Legislative Guide on Secured Transactions, chapter X, paragraphs 39 to 54, pages 392 to 396.

4.4.3.3. claims are located in the Member State within the territory of which the third party required to meet them has the centre of his main interests or its "COMI".

4.4.4. It is not clear whether the categories in Article 2(g) are exhaustive or whether assets which do not fall within them are subject to the conflict rules outside the EUIR. If exhaustive, Article 2(g) appears to subsume diverse types of asset into restrictive categories which are not necessarily a good fit at the margins of that diversity; if not exhaustive, Article 2(g) does not appear to cater for the full range of assets. In either case, the FMLC believes that Article 2(g) gives rise to uncertainty.

4.4.5. By way of example, it is unclear whether a fungible security held through multiple intermediaries or a share in a private company falls within the third limb of Article 2(g). It should also be noted that some assets appear to fall into more than one category: a ship or aeroplane, for instance, presumably falls into the tangible category whilst the ownership of it likely falls into the public register category.

4.4.1. The third limb, in particular, gives rise to legal uncertainty.

4.4.1.1. This limb provides that the location of a claim is determined by reference to the COMI of the relevant debtor. This rule can lead to surprising outcomes. A bank account, for example, held with a UK branch of a French bank would, for the purposes of the EUIR, be situated in France (the bank's COMI). To take another example, a simple contractual debt owed by an individual would be located in the COMI of the individual and its *situs* would track changes in that COMI, unbeknownst to the creditor and notwithstanding a contractual provision to the contrary.

4.4.1.2. The rule in the third limb of Article 2(g) also appears inconsistent with other conflicts provisions of EU law. Other EU legislation affecting intangible property refers to the law of the place where the relevant account is maintained (this is also known as the place of the relevant intermediary approach or "PRIMA").[10] The EUIR takes a different (ie. COMI-based) approach to the identification of a claim's *lex situs* and this inconsistency creates legal uncertainty. Assets held by corporates may, for example, be subject to conflicting rules in the EUIR and the Directive on financial collateral.

4.5. <u>What constitutes an "effect" for the purposes of Article 5</u>

4.5.1. Article 5 provides that "the opening of insolvency proceedings shall not affect" rights *in rem*. As discussed below, views differ as to what constitutes an "effect" for the purposes of the Article.

4.5.2. One view is that a stay on the enforcement of a security interest does not "affect" a right *in rem* because it only postpones enforcement. On this view, Article 5 does not protect a creditor from a moratorium imposed under the law of the Insolvency Forum.

4.5.3. Another view is that Article 5 does protect a right *in rem* from a stay on its enforcement because the right of enforcement is fundamental to the right *in rem* itself. There is some agreement amongst legal practitioners that this second argument is in line with a purposive approach to the Article's interpretation and that it represents the better view. Nevertheless, in the absence of jurisprudence, the FMLC argues that it remains difficult for a clear legal opinion to be provided on this point.

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[10] This is the approach taken, for example, in the Directive on financial collateral arrangements (Directive 2002/47/EC) and the Settlement Finality Directive (Directive 98/26/EC). It is also the rule expected to appear in any future legislative proposal for a securities law Directive and, the FMLC is given to understand, the rule which may feature in the ultimate text of the Regulation on improving securities settlement in the European Union and on central securities depositories (see http://ec.europa.eu/internal_market/financial-markets/central_securities_depositories_en.htm).

4.6. Protection of the underlying asset

4.6.1. It is unclear whether Article 5 protects only the right *in rem* or whether it may insulate the creditor's interest from the effects of the law of the forum by preventing the destruction or dissipation of the asset itself.

4.6.2. Under the laws of some Member States, a claim may be discharged or otherwise compromised during insolvency proceedings. If, therefore, Article 5 does not operate to protect the underlying asset, in the event that a claim is discharged or somehow compromised, a secured creditor will not be able to rely on the Article to enforce the full amount of the security.

4.7. The distribution of proceeds and the ranking of claims

Article 4(2)(i) provides, *inter alia*, that the law of the Insolvency Forum determines the rules governing the distribution of proceeds from the realisation of assets and the ranking of claims. It is unclear what effect Article 5 has on Article 4(2)(i) where the Insolvency Forum's rules on the ranking of secured claims are different to those of the Member State in which the asset is located.

4.8. Further points of uncertainty arising from Article 5

Further points of uncertainty arising from Article 5 include (i) the Article's application to assets situated outside the EU; (ii) the protection afforded by Article 5 to income (or other assets) generated by assets after the opening of insolvency proceedings, including where that income is generated in the Insolvency Forum; and (iii) the ability to appoint a receiver under Article 5 and the nature of the receivership resulting therefrom.

5. Article 6 (*Set-Off*)

5.1. Article 6 provides that insolvency proceedings will not affect a creditor's set-off rights where such set-off "is permitted by the law applicable to the debtor's claim". It is not clear, however, to what law this provision is referring. It may be thought to be referring to contractual set-off rules, insolvency set-off rules (of which in the UK, for example, there are several types) or both.

5.2. Some jurisdictions continue to draw a distinction between set-off and close-out netting. In light of this, an express declaration to the affect that Article 6 covers close-out netting would increase certainty. A netting safe-harbour of the type found in Article 25 of the Credit Institutions Winding Up Directive (Directive 2001/24/EC) could be helpful in this regard.

5.3. Clarity is also needed as to whether a right of set-off must arise before the opening of insolvency proceedings in order to obtain the protection of Article 6.

6. Article 13 (*Detrimental Acts*)

6.1. Where an insolvency practitioner has a *prima facie* right under the law of the Insolvency Forum to "avoid" (in the sense of voiding) an act done because it has harmed creditors—the act in question is likely to have been a contractual undertaking—Article 13 provides that the law of the Insolvency Forum will not apply if the beneficiary of the act proves (i) that the act is subject to the law of a state other than the Insolvency Forum and (ii) that the act is not "avoidable" under that law. The effect of Article 13 is, therefore, to allow the beneficiary of an act to prevent the act's "avoidance".

6.2. Uncertainty, however, arises in the operation of Article 13, not least, because it can be unclear to which state's law an act is subject: it might, for example, be unclear whether an act is subject to the law of the state where it is agreed or where it is carried out.

7. Intra-group insolvencies[11]

7.1. The FMLC is given to understand that, in the absence of provisions concerned with the regulation and coordination of intra-group insolvencies in the EUIR, market practice has, broadly speaking, been to take a cooperative approach to such insolvencies. This approach is perceived by many market participants as flexible and successful in maximising value for creditors.

7.2. The FMLC believes, nevertheless, that certainty in intra-group insolvencies would be improved by the imposition of binding duties, equivalent to those found in Article 31 of the EUIR, on liquidators. Article 31 sets out requirements for liquidators in main and secondary proceedings to cooperate and communicate. Any duties introduced could also resemble those found in the UNCITRAL Model Law on Cross-Border Insolvency.

8. Secondary proceedings

8.1. The decision whether to open secondary proceedings in the case of an insolvency subject to the EUIR is characterised by considerable judicial discretion in the court of the state in which the secondary proceedings are sought. The FMLC is given to understand that this discretion has, in general, proved effective in terms of maximising value for creditors.

8.2. Notwithstanding this fact, the FMLC takes the view that the EUIR should require a court to be satisfied that secondary proceedings are appropriate and necessary in order to minimise the practical uncertainty that may be caused by the continual threat of secondary proceedings and/or by proceedings actually initiated by creditors for speculative and/or improper purposes.

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[11] Intra-group insolvencies may take a wide number of forms: the size and geographical spread of the insolvency will vary, there may be a dominant insolvency in a single jurisdiction or, as in *Nortel* [2011] EWCA Civ 1124 for example, there may be several parallel insolvencies taking place concurrently. The discussion here is concerned principally with this latter group.

8.3. In order to increase coordination, a court considering opening secondary proceedings should, the FMLC believes, be put under a duty to notify the insolvency practitioner in the main proceedings (assuming the request for the opening has not come from that practitioner) and to provide said practitioner with the opportunity to make formal representations regarding the decision.

9. Conclusion

In view of the foregoing, notwithstanding the fact that jurisprudence may be expected to provide further guidance on some of the issues referred to above in due course, the FMLC believes that clarification of the points raised by way of amendments to the EUIR and, further or alternatively, the publication of an expert report,[12] will provide for more efficient and predictable insolvency outcomes for the market.

[12] A report regarding the Convention on Insolvency Proceedings which was published in 1996 (the "Virgos-Schmit Report"). The report can be accessed at the following address: http://aei.pitt.edu/952/1/insolvency_report_schmidt_1988.pdf.

APPENDIX I

Uncertainty as to a right *in rem*: CREST – an illustrative example[13]

CREST is the UK's securities settlement system.

CREST members hold securities and cash accounts in the CREST securities settlement system. Each CREST member has a relationship with one or more CREST settlement bank.

A CREST settlement bank relies on an irrevocable power of attorney given by way of security to facilitate the enforcement of rights over assets held by CREST members in the system. Under the insolvency law of certain jurisdictions (for example the Netherlands), however, existing authorisations are revoked by operation of law on the insolvency of the donor of the authorisation.

Uncertainty exists, therefore, as to whether a power of attorney, taken from a CREST member subject to the insolvency law of a Member State other than the UK, will survive the insolvency of that member.

This uncertainty has cast doubt on the security structure underpinning the participation of non-UK incorporated entities in CREST. CREST settlement banks may feel that they have no choice but to limit the credit that they extend to such members and to reduce their exposure to those members at an earlier stage than they might otherwise have done.

It is anticipated that the uncertainty described above will be the subject of a specific paper from the FMLC which may propose, as one of its solutions, that the EUIR be amended to state explicitly that a power of attorney is a right *in rem*.

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[13] For the purposes of this discussion, Directive 2001/24/EC on the reorganisation and winding-up of credit institutions may also be relevant. The FMLC notes the use of the term right *in re* in that Directive. The FMLC believes that this represents an unfortunate divergence of terms.

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[14] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

Following her appointment as assistant to the UK Reporter to the study on the reform of the European Insolvency Regulation Joanna made no further substantive contribution to this paper.