Andrew Shore, Policy
The Insolvency Service
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Dear Andrew

RE: Implementation of Article X

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") 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 proposal to implement "Article X" of the UNCITRAL Model Law on Recognition and Enforcement of Insolvency-Related Judgments through amendments to the Cross Border Insolvency Regulations 2006 ("**CBIR**") has the potential to create significant uncertainty and in our view is likely to have a negative impact on the wholesale financial markets.

The Importance of the Certain Application of English Law

The rule in Gibbs [*Antony Gibbs & Sons v La Société Industrielle et Commerciale des Métaux* (1890) LR 25 QBD 399] (the "**Rule**") provides a welcome and predictable basis for contracting parties, ensuring that their choice of law is respected and not subject to the intrusion of other laws. This is particularly important when the framework for the recognition of cross-border insolvency laws does not have its own clear choice of law rules.

While we appreciate from the consultation text that it is not the Government's intention to undermine or overturn the Rule, without an express statement in the proposed legislation to this effect, we are concerned that the Rule will not be preserved, as commentary included in the consultation will not be binding on the courts when considering an application for recognition of an insolvency related judgment. As the Rule is founded in common law and Article X will be part of the formal legislative framework contained within the CBIR, the doctrine of supremacy means that it will not be clear that Rule is to be preserved over the amended legislation. In addition, the proposed amendment to the CBIR provides discretion for the court to recognise foreign judgments (without any specific exclusions or safeguards)[1] which inherently creates a new uncertainty about the outcome of any such proceedings.

The discretionary nature of Article X and the lack of necessary safeguards creates material uncertainty for the financial markets, and its adoption should be considered carefully.

Below we have set out some specific examples of where uncertainty created by Article X may be particularly problematic.

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[1] Noting that that the proposed amendment relies on the recognition of foreign law insolvency proceedings under the CBIR which does itself already contain some exclusions.

Collateral Arrangements, Netting and Set off

Impact of uncertainty

A large number of English law governed financial contracts (including derivatives, stock lending and repo transactions) are entered into under netting agreements that are designed to give each party a net exposure to each other. The efficient operation of the wholesale financial markets is predicated upon the enforceability of these agreements in the event of the insolvency of a counterparty. Furthermore, for such a netting agreement to be recognised for regulatory capital purposes, banks and investment firms are required to have written and reasoned legal opinions to the effect that, in the event of a legal challenge, the netting arrangements would be enforceable. Without suitable legal opinions, the amount of regulatory capital a bank or investment firms is required to hold in respect of the counterparty exposure would be the same as if no netting agreement existed. This is likely to be much higher than the amount of regulatory capital that is required at present, significantly undermining the profitability of the banks or investment firms in question.

If Article X were implemented in its current form, providing an unqualified legal opinion that the netting arrangements would be enforceable in the UK may be problematic, as advisers would have to consider the discretion given to the court to recognise foreign law insolvency judgments. In other words, if there is a possibility that a foreign law insolvency judgment providing for (for example) the writing down of claims against the insolvent entity would be recognised in the UK, the English law legal opinions on which banks and investment firms rely would have to include a qualification to this effect. This may mean that the netting arrangements could not be relied on for regulatory capital purposes.

Potential Safeguards

The European Insolvency Regulation ("**EUIR**") which, *inter alia*, provides for the recognition of insolvency judgements across the EU, includes express safeguards for these particular types of arrangements. For instance, Article 8 of the EUIR excludes third parties' rights in rem on assets of a debtor located in another jurisdiction from insolvency proceedings, Article 9 of the EUIR excludes set-off and Article 12 provides that the effect of insolvency proceedings on rights and obligations of parties to a payment system or to a financial market shall be governed by the law that is applicable to that system or market.

If Article X is to be implemented, the UK courts will have the discretion to recognise a foreign insolvency-related judgment that applies foreign insolvency law and so, in effect, the UK courts will be able to apply foreign insolvency law. This should only be possible if there are clear choice of law rules as to when the foreign insolvency law should not apply. In addition to the inclusion of similar safeguards to those under the EUIR, we would recommend an express netting arrangement carve out for those arrangements which are not covered by the financial collateral directive (where there is no financial collateral). We are also of the view that further consideration ought to be given to extend protections to creditors' rights to terminate contracts. Clear exclusions and specific carve-outs are needed to minimise the issues of uncertainty and maintain continued certainty of application of English law in these areas.

Suggested Amendments to Schedule 1 of the CBIR

In terms of the implementation proposed by including Article X as a document to be taken into account under Regulation 2 of the CBIR, we query whether an amendment to the relief available and contained in the existing Article 21 of Schedule 1 may be a more

logical place to include any changes and may be more effective in creating the legal effect the proposal aims to achieve.

This Schedule also already contains various protections in respect of the relief presently available in the context of the recognition of insolvency proceedings themselves. For example, Article 20(3)(c) of Schedule 1 of the CBIR preserves rights exercisable under or by virtue of or in connection with the provisions referred to in Part 7 of the Companies Act 1989; Part 3 of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999; and Part 3 of the Financial Collateral Arrangements (No 2) Regulations 2003 ("**FCAR**") or where they interfere with or are inconsistent with any rights of a collateral taker under Part 4 of the FCAR. By way of further example, Article 20(3)(d) also protects creditors' rights of set off against the claims of a debtor. These protections do not apply in relation to the discretionary relief that is available under Article 21 of the CBIR but they set a useful precedent for the types of protection that could be built into the new discretion to recognise an insolvency-related judgment.

Whilst there are more general protections in respect of the discretionary relief available in connection with the recognition of insolvency proceedings, for instance, pursuant to Article 21(2) the court must be satisfied that the interests of creditors in Great Britain are "adequately protected" and likewise under Article 22(1) the interests of the creditors (including secured creditors) and other interested parties need to be "adequately protected" in the context of the court making any orders under the CBIR, the notion of "adequate protection" injects uncertainty. There is very little UK case law on the meaning of "adequate protection" (which has its origins in the US bankruptcy system) and so we are concerned that any reliance on this uncertain concept, will mean that parties are unable to rely upon contractual arrangements, not least because of the lack of understanding as to what this phrase means in English law and how the English court may interpret it in any given case.

We are of the view that, if amendments are to be made to include the recognition of insolvency related judgments, further clarity could be given in this regard, and as suggested above more express choice of law provisions (similar to those in the EUIR) ought to be considered in the context of recognition of insolvency related judgments.

Interaction with the Banking Act 2009 ("BA") and Limitations of the Entity Based CBIR Carve Outs

We understand that, since the recognition of insolvency related judgments must be in connection with insolvency proceedings that have themselves been recognised under the existing provisions of the CBIR, the scope of those judgments will be limited in the same way. For example, judgments related to credit institutions and other regulated entities as provided for by way of example in Article 1(2)(h) and (i) of Schedule 1 of the CBIR which excludes credit institutions including third country credit institutions will not be within its extended scope. In addition, we assume that since the resolutions are not derived from insolvency law they would not be recognised as insolvency proceedings and therefore would continue to be considered for recognition by the Bank of England as an instrument under section 89H(2) of the BA.

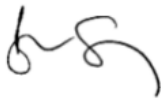
However, it is worth noting that these entity exclusions would not extend to holding companies and subsidiaries of such entity types, and this may give rise to uncertainty in how they may be treated in practice where for example the whole group is subject to a formal process. Nor does it appear to extend to all possibly relevant entities that may be an integral part of the financial system, for example, investment firms.

For these reasons, we do not think the entity based carve outs in the CBIR alone are sufficient to mitigate the uncertainty Article X introduces into the financial markets, and could leave certain financial institutions worse off than others who are carved out, and can rely on the certain application of English law.

In conclusion, it is our view that the suggested implementation of Article X will create material uncertainty in the wholesale financial markets and that the continued certain application of English law should instead be expressly preserved. Failing this, detailed safeguards and exclusions would need to be introduced to mitigate the impact of the inherent uncertainty caused by the discretion Article X affords the court for financial contracts and for financial institutions.

We would encourage the Insolvency Service to give detailed consideration to the points raised in this response. Please do not hesitate to contact me should you wish to arrange a meeting or if you have any questions.

Yours sincerely,



Brian Gray
FMLC Chief Executive[2]

[2] FMLC acknowledges the assistance of Jennifer Marshall of Allen and Overy LLP, Gabrielle Ruiz and Christopher Bates of Clifford Chance LLP, and Simon Firth of Linklaters LLP in writing this letter.