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Financial Law Committee response to Ministry of Justice consultation on draft EAPO Regulation

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 18 specialist committees. This response in respect of the draft EAPO Regulation has been prepared by the CLLS Financial Law Committee. We have also read, in draft, the response of the CLLS Litigation Committee and endorse its conclusions and suggestions, save in one respect which is noted below.

This response raises serious concerns that the proposals in their present form carry a real risk of:

- irremediable injustice to defendants,
- serious damage to businesses and individuals, and
- over-riding of the interests of secured creditors and of banks with set-off and netting rights.

In addition, the proposals do not deal fully with the risks to financial and securities trading systems and markets and create new legal uncertainties, as well as seeking to impose the costs of the legislation's methodologies and uncertainty on the banking sector.

They would require substantial changes to the way business is conducted, would seem calculated to discourage cross-border trade and do not work effectively with the present discretionary remedies to protect defendants against whom equivalent orders are now made by the English courts – in particular because it does not appear certain that discretionary relief can be granted by the receiving court under the new regime and this may result in defendants being bankrupted as a result of one of these orders and being deprived of their rights of defence.

While we would welcome a properly safeguarded simplification of the systems for preservation of assets pending judgment and the enforcement of judgment debts, in cases where such measures are truly necessary, we believe that in their present state these proposals are claimant friendly to the point where they fail to balance the interests of the defendant and dependants of the defendant (employees, customers and family of individuals) with those of the claimant and are not fit for purpose.

Reluctantly, therefore, we conclude that the risks to UK businesses and citizens are such that the UK should exercise its right to opt out of this legislation. The UK should, of course, press its reasons for doing so and be prepared to opt in if sufficient safeguards and clarity are introduced into the proposals.

Although the remit of this Committee is concerned primarily with the wholesale financial markets and serious issues in relation to these are raised below under the heading "Problems from a bank's perspective", we deal first with the problems for a defendant against whom an EAPO is made. These will fall on businesses large and small and on individuals. We believe that they will fall most severely on smaller businesses and individuals, which are most at risk of having their entire financial resources frozen and whose borrowings may be put into default and made immediately repayable as a result of one of these orders, however unjustified its issue may have been. There is no provision to enable them to release funds to pay the legal costs of defending themselves and the position on the protection of the viability of English businesses and of the homes and livelihoods of affected individuals seems singularly uncertain.

We cannot see how the EU authorities can regard this proposal as consistent with EU duties to protect the rights of defendants arising under both EU law and the ECHR, since it sets no minimum standards of protection and would allow the chance of interaction between originating and receiving state rules to remove all protections for the defendant.

Problems from a defendant's perspective

- Far-reaching consequences: Not only may a defendant be unable to access its bank accounts, it might suffer penalty costs, opportunity costs and costs of challenging the order, potentially in a Member State other than its own. The EAPO regime would seem to make pre-decision orders much commoner than they are in domestic procedures. Pre-decision freezing orders have a blackmail effect, if it is costly to get them changed and the amount claimed may be hugely exaggerated.

- Event of default: an EAPO (even if subsequently found to have been wrongly granted) could constitute an event of default under a loan agreement and possibly the ISDA Master Agreement. This is because, unlike the equivalent English freezing order, these orders take effect in rem (ie against the frozen assets), not in personam, as is the case with a English order of equivalent effect which is addressed to the defendant and does not attach to assets as such. While some post judgment enforcement measures in England may take effect in rem, they are only used after the defendant has had a judgment made against it and an opportunity to pay, but an EAPO can be obtained without any such opportunity being afforded to the defendant and, indeed without proceedings having been commenced. This has the potential to cause withdrawal of banking facilities from a company subject to an EAPO, even if the claim proves entirely unfounded (pre-judgment EAPO) or would be met in full without any need for an EAPO (post judgment EAPO, which has a very low threshold for issue). Time would be needed to adjust relevant wording in existing documents to remove or ameliorate this effect, but there can be no certainty that lenders will be willing to make such changes in every case. Given that an EAPO may itself take effect as if it were a first fixed charge on the frozen account and rank ahead of nearly all other creditors (including creditors with a pre-existing floating charge, right of set-

off or netting right, as well as unsecured creditors) lenders may be unwilling to risk continuing existing lending or extending further lending when one of these orders has been made against a borrower.

- *Ex parte* application: an *ex parte* applicant will not owe a duty of full and frank disclosure to ensure the court is aware of all relevant facts. The claimant can therefore put its arguments to the court in order to obtain an EAPO, with no automatic consequences for failing to give the court the full picture.

- Well-founded test: The explanatory memorandum interprets this as meaning that the claimant has to show that he has a good prospect of winning his case on the substance, but this wording does not appear in the Regulation. There is uncertainty as to how this phrase will be interpreted and whether this would be equivalent to the standard understood in English law as "a good arguable case". The standard may be more formal (i.e. that the claimant demonstrates that it asserts the elements of a pecuniary claim that meets the standard required by the court for the issue of proceedings) and lead to EAPOs being issued more readily than UK freezing orders prior to judgment.

- Real risk test: The test is that "without the issue of the EAPO the subsequent enforcement of an existing or future title against the defendant is likely to be impeded or made substantially more difficult". While the Regulation includes as an example the real risk that the defendant might remove, dispose or conceal assets, the test could be satisfied in other ways, potentially without any actual risk of the defendant deliberately removing, disposing of or concealing assets for the purpose of defeating creditors. As such, the test is open to allowing applications with little evidence and mere speculation, and may be used to improve the position of one creditor against another, rather than to prevent deliberate removal of assets by the defendant with the purpose of defeating creditors. There appears a real risk that orders will be obtained in circumstances where they would not currently be available and where they cause substantial damage to a party which would not seek to evade payment of its due debts.

- Definition of monetary claim: It is not clear whether this extends to claims for damages, but there must be a high risk that it will be so interpreted and not limited to claims for debts owing under a contract or statutory provision. Damages claims are often massively overstated when proceedings are first initiated and even debt claims (eg where there is a dispute about whether an event of default accelerating repayment of a loan agreement or closing out a futures position has occurred) may be asserted to be many times the amount actually due. In these circumstances the risk of an EAPO extending to all the financial assets of the defendant is much increased.

- No discretion: Once the requirements for an EAPO are met, the courts do not seem to have a further jurisdiction as to whether to grant an EAPO. The Regulation says that the court "shall" issue an EAPO if the requirements for issue are met.

- Fewer conditions where claimant has a judgment: The well-founded test will not apply where the claimant already has an enforceable judgment against the defendant, even if it is a default judgment. In such case, the only pre-condition is the real risk test. Orders can be sought without any effort to get the defendant to pay or time for it to apply for a stay of execution or for scheduling of payments over a period (options courts in many countries would allow to a defendant). In

addition there is no distinction made between default judgments and judgments on the merits. There seems a real possibility that without greater safeguards, a order could be used in some circumstances to prevent the defendant funding an appeal or application to set aside a default judgment, even in circumstances where there is a dispute about whether the defendant ever had any notice of the commencement of the proceedings.

- Accounts with a third party interest: These accounts can only be frozen to the extent permitted under the national law of the Member State. This means that there may be some important distinctions in approach throughout Member States. There is no minimum standard of protection for other parties interested in such an account.

- Right to defend underlying case There is lack of any provision for defendant's access to funds to take steps to defend proceedings/set aside judgment.

- Defendant challenge: there are only limited grounds of challenge and it does not seem that discretionary relief can be sought. Any challenge must be made within 45 days of "the day the defendant was effectively acquainted with the contents of the order and was able to react". This seems likely to be the subject of litigation. Further, the court has 30 calendar days from service of the defendant's application on the claimant to give its response, a long timetable compared to that for dealing with the claimant's application for an EAPO. This is fundamentally unfair and the time period is long enough to bankrupt the defendant and, in the case of a business, to require the defendant to close down operations and lay off employees or go into administration, if the order disrupts cash-flow.

- Security to be given by claimant: The court has a discretion to order this if national law permits. Different approaches are likely to be taken in different Member States. No guidance is given in the Regulation as to when the court should require security or the sum in which security should be given. The claimant is under no duty of full and frank disclosure or other obligation to inform the court of any damage it knows that an EAPO will cause the defendant, so the court might not know what damage the defendant is likely to suffer as a result of an incorrectly granted EAPO, especially as the defendant has no right to be heard.

- Amounts to be exempted for livelihood and to pay rent, mortgage and loan interest on homes and key business premises and to pay salaries: Amounts will be exempted depending on the national law of the Member State of enforcement. This will therefore vary widely in practice. Further, the Regulation gives this decision to the competent authority; it is clearly viewed as an administrative matter – it is wholly unclear who that might be in England as this matter is treated here as one for the courts. In England the amount to be exempted from a freezing order is often a contentious question and is decided by a judge, who has the benefit of full and frank disclosure given by the claimant and the defendant's evidence as to his needs. It is far from clear that existing English protections will be available at all, and it may be that English law would need to be changed to enable such remedies to be available – however, a change to the law after the EU legislation is enacted (and possibly even before) may not be permitted under EU principles that it raises a new barrier to free movement of capital (ie the ultimate proceeds of the freezing order).

We note that, in this one respect, we do take a different view from the the CLLS Litigation Committee, which suggests that these reliefs should be granted by the issuing court applying the law of the receiving State. This is because such a rule is likely to make obtaining relief difficult, costly, slow and somewhat capricious, given that very different social and legal conditions obtain in different Member States which may make the appreciation of each other's laws, particularly discretionary relief rules, unsatisfactory. Where the body granting relief is an administrative bod.y not a court, it may not have appropriate expertise or jurisdiction. In the case of EAPOs issued to multiple receiving States, we would suggest that this relief is given by the courts or administrative bodies of the State of the defendant's domicile/habitual residence.

- Open to misuse: It seems possible that a claimant could invoke the disclosure of account information procedure by simply presenting the name of the defendant (for example, "John Smith"), obtain the addresses and account details of every John Smith in the UK, issue substantive proceedings against multiple defendants in another Member State, get dubious default judgments and obtain an EAPO freezing all the UK accounts in the name of John Smith in the hope that a number will just pay up - particularly if the amounts claimed are relatively small. Even an honest claimant may get the wrong defendant and there is no redress for the defendant in that case: in relation to the European arrest warrant, there have been cases of mistaken identity leading to wrongful arrest and mistake seems much more likely in the private pursuit of financial claims than in the field of criminal law, with its much greater checks and balances. The consequences of mistake should be clearly borne by the claimant not an innocent party or its bankers.

- Open to Fraud There appear to be no protections at all if there is a systematic attempt to use the system fraudulently – i.e. to make spurious claims against wholly innocent parties in another Member State and backing them with freezing orders enforceable in the UK. The spuriousness of the claim would have to be established in the first Member State, the resources needed to defend could be frozen and, if a judgment, even a default judgment has been issued, it may not be possible to get it set aside. There should be a mechanism for a Member State to opt out of accepting EAPOs from any Member State where fraud appeared to have become a significant issue.

- Risk of reduction in interstate trade and interstate e-commerce Although these risks could not be wholly avoided if a business trades only within a single Member State, they would be reduced. A few well publicised examples of the damage these orders could cause to innocent parties would be likely to result in many smaller businesses seeking to reduce the risks by trading only within their home Member States and with third countries, in respect of which these excessive powers would not exist. Individuals may also be deterred from travel and from using international selling services such as e-bay (a private seller would not have the benefit of access to home State courts afforded to a consumer or an employee).

Problems from a bank's perspective

- Definition of bank account: dealing with securities accounts: The inclusion of financial instruments in the definition is likely to cause problems for banks. For example, if a single bank has one bank account containing cash and another containing financial instruments, both belonging to the defendant and responsive

to the EAPO, neither of which alone reaches the value of the EAPO, but which together reach the amount of the EAPO, the bank may have to choose which account is to be frozen and to what extent. The Regulation gives no guidance as to how this choice is to be made, and there is no obligation on the bank to make the choice that is most advantageous to the claimant or to the defendant.

- Definition of bank account: definition of securities: It is unclear whether swaps and other derivatives fall within the definition. If they did, careful consideration of the treatment of close out and setoff/netting would be needed, so as to ensure that it remained enforceable. Changes to documentation and the terms of existing arrangements may be needed, and this would require a long introduction time, given the volume of documents involved, and so as to avoid unnecessary jeopardy where unreformed documents continue in use.

- Definition of bank account: jeopardy in relation to intermediated securities: The exception for systems in relation to freezing of securities accounts may well not be wide enough. Intermediated securities can be held through a chain of intermediaries and each will be regarded in most jurisdictions as holding securities on behalf of their customer. However, if the account of an intermediary in the middle of the chain is frozen, then it is its customers who suffer, not just it. There would need to be special provision to protect accounts declared to hold only securities (or rights in relations to securities) of customers of the account holder and/or rights which would enable the account holder to meet obligations to deliver securities to the order of their customers. This is important to avoid systemic risk in the securities markets and damage to the customers of a defendant intermediary.

- Exclusions need extension: While the bank accounts of a securities system and the securities system itself may be protected from EAPOs, there is no equivalent protection for monetary clearing systems or for the operators of other important exchanges – eg commodity exchanges, where interruption to settlement procedures would be extremely damaging to the system, its participants and their counterparties and customers.

- Bank's liability for breach: If a bank fails to comply with an obligation with regard to an EAPO, the bank's liability is governed by national law. Therefore, there will be differences as to adverse consequences in different Member States. Banks risk being sued for negligence e.g. where the wrong account or accounts are frozen, perhaps due to inaccurate information supplied by some other agency.

- Cost of searching: At present, if a freezing order is granted the onus is on the applicant to contact each bank which it believes holds assets of the respondent to the freezing order. It can sometimes be days before the bank is able to conduct a search and confirm whether or not the respondent holds an account with it. In the past the consequent expense has been something that English banks have been prepared to “take on the chin”, often not even troubling to charge the claimant for the cost of their search, despite being entitled to. That cost may, however, now be multiplied.

- Cost of implementing orders: Banks will be entitled to payment of their costs of responding to search requests or implementing EAPOs only where they are entitled to be paid under national law. Whilst the UK government would presumably introduce fixed search and execution fees for banks to the extent it can do so in advance of the implementation of the new legislation, any such

scheme of charges would be unlikely to bear any relation to the actual costs incurred, and it seems unlikely that this revenue stream will completely offset the banks' costs of compliance. Banks may respond by passing on the costs of the new requirements to their customers.

- Accounts subject to a pre-existing charge: The Regulation is silent as to how bank accounts that are encumbered by a charge in favour of the bank or a third party should be dealt with. There is nothing which clearly protects third parties who have rights against accounts in the name of the defendant may become subject to an EAPO, and there is no specific protection for the claims of the bank itself. Although an EAPO cannot be used in relation to a claim in the bankruptcy or insolvency of the defendant, it seems that a pre-existing order would not be discharged on the bankruptcy or insolvency of the defendant. Thus, it seems likely under English law (which would apply to ranking issues pursuant to Article 33) to take effect as a fixed charge and rank ahead of a prior floating charge, notwithstanding a negative pledge clause, and of a subsequent fixed charge on the same account, even though parties dealing with the company will not be able to identify the existence of the order through a search at Companies' Registry. Most current English equivalent orders operate in personam, not in rem, and would not have this effect, but we do have an in rem remedy to which an EAPO would probably be equated. In rem orders are only available in England in relation to a judgment after time has been allowed for payment and an insolvent defendant would normally have gone into bankruptcy or administration before that point was reached; in addition, there would be no risk where such an order were in place, of an excessive provisional claim tying up funds that should be available in the insolvency, but this seems a real risk with an EAPO.

- Bank's right of set-off: The Regulation does not appear to address this. If a defendant has two accounts at a bank, one in credit but another in debit, the account in credit might be attached by an EAPO, potentially leaving the bank at a disadvantage by depriving it of any rights of set-off against those monies standing in the account in credit. In England and Wales, standard freezing orders expressly provide that they do not prevent the bank from exercising any right of set-off it may have in respect of any facility which it gave to the respondent before it was notified of the order.

- Netting arrangements: In groups of companies, there are frequently netting arrangements in place involving all accounts of members of the group with their principal banker. If these have to be wholly or partly suspended as a result of an EAPO, there are cost implications for the group (not just the defendant company), with some risk of contractual default, and the bank will have to provide for its lending to the group for capital adequacy purposes excluding the frozen account(s).

- Other rights of banks: the Regulation is silent on the degree to which banks can use the money in the account for their own legitimate purposes. For example, under English law, banks are able to settle pre-existing transactions on the account.

- Timing: the bank must implement the EAPO "immediately" upon being served and within 3 days it must issue a declaration. There is no guidance as to what is meant by "immediately" (save that if the EAPO is received outside business hours, implementation can be delayed until the next business day), and there is

no provision for a bank to seek an extension of time. This is likely to increase administrative costs for banks.

- Insolvency Risk: Although an EAPO cannot be used in relation to a claim in the bankruptcy or insolvency of the defendant, it seems that a pre-existing order would not be discharged on the subsequent bankruptcy or insolvency of the defendant. While an individual would probably receive the relief available under bankruptcy law to enable him or her to live and work, the rest of the funds may remain frozen and other creditors unpaid. In a corporate insolvency, there would seem to be a risk that no, or much reduced, funds would be available to the administrator to fund the insolvency process. This would be likely to result in welfare losses to all classes of creditor and to employees, as it may be impossible to preserve the business for sale.

General issues

- Alternative to national remedies, rather than replacement: It is unlikely that the European procedure and domestic procedures will simply sit beside each other as alternative options. There will be situations in which it is expedient to obtain both an EAPO and the equivalent domestic order. In those cases, two regimes will be applicable to the same situation, and there will be overlapping and conflicting obligations on the parties. It is unclear how this will work in practice.

- The claimant is responsible for releasing any surplus funds and may have a choice as to which assets it retains and which it releases. No guidance is given as to how this choice should be exercised, and in fact the claimant will not know which of the accounts are the most advantageous to retain. Additionally, it is not clear if the claimant will be liable to the defendant if it fails to release accounts within the 48 hour time limit of discovery of the surplus.

- *In rem / in personam*: An issue arising from the distinction between *in personam* and *in rem* remedies is that there are significant issues as to how they operate internationally. Each has its limitations, which could reduce the effectiveness of the EAPO regime.

- No right of disclosure: An EAPO does not give a claimant the right to obtain disclosure from the defendant of information relating to the defendant's assets more widely. This means the EAPO process could be less attractive to a creditor: for example a victim of fraud would need to apply for further order and may prefer an English freezing order (perhaps combined with *Norwich Pharmacal* relief).

- Jurisdiction conflicts: The jurisdiction rules mean it is unclear whether a pending but undetermined challenge to the jurisdiction of the courts seised with the substantive dispute will jeopardise a creditor's ability to obtain an EAPO. The only practical answer to this must be that such a challenge will not disturb the validity of an existing EAPO. However, satellite litigation relating to jurisdiction is likely to arise.

- Central register: Creating a register is likely to raise many concerns, including regarding data protection and the security of such a database.

- Obtaining bank details: It seems odd that a foreign claimant, using the EAPO process, will be able to obtain information about bank accounts (including accounts not needing to be frozen to meet its claims) which is not available to

nationals in a purely national case. Will the availability of this information process, compounded by the wide definition of "cross-border" disputes, allow fishing expeditions by creditors? The claimant only has to provide limited information about the defendant to start the EAPO process, and the process for obtaining information, running. Clear duties of confidentiality should be placed on the claimant and its advisers in relation to any information released to it and the Regulation should require that Member States create a criminal offence if the information is used otherwise than in connection with the EAPO (where no suitable offence already exists). Of course these duties may be small consolation to the defendant if there has been actual misuse of the data, which makes the following point particularly important.

- Lack of standard identification procedures for claimants: Claimants can make applications by email and without legal representation meaning that they will not have been subject to anti-money laundering or identification checks. This would also increase the risk of fraud affecting defendants. The proposals should require that the claimant provide information for these standard checks to the bank and that these be satisfactorily checked before any data is released to the claimant and that if this in not done within a very short space of time, the EAPO should be released and not reinstated until the defect is remedied.

Dorothy Livingston

Chairman
City of London Law Society,
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THE CITY OF LONDON LAW SOCIETY
FINANCIAL LAW COMMITTEE

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