



Proposed EU Regulation creating a European Account Preservation Order

Ministry of Justice consultation Response by R3, the insolvency trade body

If you are a representative of a group, please tell us the name of the group and give a summary of the people or organisations you represent:

The Association of Business Recovery Professionals ('R3') represents insolvency practitioners authorised to practise in all jurisdictions in the UK. Around 97% of insolvency practitioners are members of R3, as well as numbers of specialist insolvency lawyers. Our members are experienced in working on UK and cross-border recovery and insolvency assignments.

Q1. Is it in the national interest for the Government, in accordance with Protocol 21 on the position of the United Kingdom and Ireland in respect of the Area of Freedom, Security and Justice annexed to the Treaty on the Functioning of the European Union, to opt in to negotiations on the Commission's proposed Regulation? Please explain the reasons for your decision.

We do not believe it is in the national interest to opt in to the proposed Regulation.

EAPOs present a tremendous risk to the UK business rescue culture. The devastating impact their introduction would have on the delicate period of pre-insolvency advice must not be underestimated. Policy makers and legislators have gone to considerable lengths in recent times to enhance the ability of skilled professionals to help struggling but viable businesses. Though well-intentioned, EAPOs are a dangerous and draconian measure that should be wholly avoided if business preservation remains a priority for the UK Government.

We do, however, appreciate that even if the UK opts out other Member States may opt in (which means that cross-border restructurings would be impacted by the Regulation). If the UK were to opt in, the national Government would be able to influence the drafting of the Regulation. Were the Government to take this approach, we strongly recommend the following revisions to protect the UK business rescue and insolvency regime:

- The Regulation should ensure that EAPOs cannot be granted to a business that is in any collective insolvency proceeding as set out in the European Insolvency Regulation. Currently the UK's formal rescue procedures are not exempted.
- The requirements for granting an EAPO should be more closely allied to their stated purpose - to prevent defendants concealing assets. This could be achieved by removing the word 'including' from the Article 7 1 (b). As currently drafted, an EAPO may be granted in all manner of cases and not only in those where there is a risk of dissipation of

assets. To protect the ability of Insolvency Practitioners and other professionals to rescue businesses through pre-insolvency advice, actions taken in a restructuring should be protected from Article 7 1 (b).

- If the introduction of EAPOs is to be no more damaging to the rescue culture than the existence of the English ‘freezing injunction’, the Regulation should ensure that the providing of a security deposit is an essential requirement in every case, regardless of jurisdiction. EAPO applicants should also have a duty to provide full and frank disclosure (to provide all material facts to the Court).
- The Regulation should specify that the granting of an EAPO will not confer priority on the applicant.
- To protect funds of third parties from creditors’ reach, it should be clear in the Regulation that nominee accounts are not available to an EAPO applicant.

Q2. What are your views on the specific issues raised in this paper concerning the proposal being made by the European Commission?

1. “Well founded” claims: Article 7 of the Regulation sets out the conditions for issuing an EAPO, stipulating that the Court must be convinced that the claim against the defendant “appears to be well founded” and that subsequent enforcement of a judgment is likely to be made more difficult without an EAPO. The article goes on to specify that where the claimant has already obtained a judgment, court settlement or other authentic instrument, the claim will be deemed well founded. However this list is not exhaustive, so Courts in each Member State will have to determine which kind of claim they consider to be well founded.

Without clearly defined criteria as to what constitutes a well founded claim, the position taken by Courts in the various Member States may diverge. This is particularly serious given the deep and immediate impact an EAPO can have on individuals and businesses based in the UK. A claimant that would not be granted an EAPO by an English Court may be awarded an EAPO, for example, in Romania that stands in the UK. To complicate matters, a Court in one Member State can grant an EAPO, while another can set it aside: as such, there is nothing to prevent this damaging process continuing indefinitely.

2. Dissipation of assets: The second criteria of Article 7 stipulates that the court must be satisfied "that without the issue of the order the subsequent enforcement of an existent or future title against the defendant is likely to be impeded or made substantially more difficult, including because there is the real risk that the defendant might remove, dispose of or conceal assets held in the bank account or accounts to be preserved".

Presumably the enforcement of any judgment would be made easier with an EAPO because the defendant’s account will already be located and frozen. As such, EAPOs are likely to be granted routinely in all debt recovery cases.

The closest equivalent to the EAPO in the English system is the 'freezing injunction' which requires the applicant to provide substantial evidence that there is a real risk of asset disposal before judgment can be obtained - e.g. evidence that the defendant has already taken steps to remove or dissipate assets, past defaults by the debtor, a history of non-compliance with court orders, other evidence of dishonesty (such as previous convictions).

As the Regulation stands, the use of the word 'including' as underlined above (our emphasis) suggests that an EAPO may be granted in all manner of cases and not only in those where there is a risk of dissipation of assets. If the idea behind the establishment of an EAPO is to prevent defendants concealing assets, the requirements for granting an EAPO should be more closely allied to this objective. This could be achieved by removing the word 'including' from the Article 7, 1 (b) so that the criteria becomes "that without the issue of the order the subsequent enforcement of an existent or future title against the defendant is likely to be impeded or made substantially more difficult because there is the real risk that the defendant might remove, dispose of or conceal assets held in the bank account or accounts to be preserved".

Please see the addendum for further consideration of this phrasing and the comparison with the English 'freezing order'.

3. Business rescue: restructuring and pre-insolvency advice

UK policy makers and those across Europe have gone to considerable lengths in recent times to enhance our business rescue culture and to work across borders to facilitate proper and fair treatment of creditors. The proposed Regulation (as it stands) could cripple the restructuring and business rescue culture of the UK and other Member States.

In 2010, DG Enterprise and Industry (Directorate Innovation) commissioned a report by the Centre for Strategy and Evaluation Services which explored Member State procedures for financial reconstruction of enterprises in financial distress. They concluded that "*The UK has a cultural, legal and professional environment that is highly supportive of reconstruction*" and go on to give credence to the view that "*well over 50% of companies that become financially distressed are usually returned to normal without the public being aware that anything was amiss*".

A vast amount of business rescue work occurs before formal insolvency begins - pre insolvency advice and restructuring. The pressure on cash flow as professionals work with businesses to turn their fortunes around outside the protections of formal insolvency cannot be underestimated. Cash flow is monitored on a daily basis to ensure that the business continues to meet its most basic requirements while its problems are addressed - simply paying wages, supplies and rent are all critical pressures on the business.

By effectively removing access to potentially substantial funds without any notice, the granting of an EAPO would give a single creditor the right to jeopardise any hope of rescue - to the detriment of the business itself, its employees and trading partners, and its creditors.

There is little doubt that an EAPO would be granted as businesses in financial distress have any number of creditors who would all be owed a sum of money (thus presumably meeting the EAPO criteria). Yet the mere creation of an EAPO during the extremely delicate pre-insolvency advice period could quite simply destroy attempts to preserve a business. While EAPOs are intended to help creditors, their impact is likely to harm creditors as their outcomes would be much better in informal restructuring than formal insolvency.

Business rescue has long been a priority of policy makers in the UK. Across Europe, legislation has also become increasingly business rescue friendly in recent times, as exemplified by the current work to reform the EC Regulation on Insolvency Proceedings (No. 1346/2000). The proposed EAPO Regulation is entirely inconsistent with this work and policy intention. In a well meaning attempt to resolve the difficulties of recovering debts across borders, the introduction of EAPOs could devastate business rescue across Europe.

4. Business rescue: formal procedures

It is also entirely unclear how the proposed Regulation would interact with *formal* rescue procedures. Article 2 stipulates that the Regulation shall not apply to ‘bankruptcy, proceedings related to the winding up of companies or other legal persons, judicial arrangements, composition and analogous proceedings’. The Commission’s intention is clearly to exempt terminal insolvency proceedings, but no mention is made of formal rescue procedures. Arguably this could be covered by ‘analogous proceedings’, but it would be unwise to rely entirely on this loosely worded phrasing.

Administration is the most common formal rescue procedure in the UK. It is used for struggling businesses that need protection from their creditors in order to facilitate a rescue plan. When a company enters administration, an Insolvency Practitioner manages the company’s affairs, keeping the business trading while seeking out a buyer or remedying its problems. As with the pre-insolvency period, cash flow is all important during the time that a company trades in administration. If a company in administration finds sums in its bank accounts frozen without notice, its prospects of rescue will be severely jeopardised. Although the moratorium ought to protect against an EAPO being made against a company in, or applying for, administration there is no European register of insolvency proceedings which covers administration - this presents the risk that an EAPO may inadvertently be made. If this were to happen, it could take considerable time and costs to reverse the process via the granting court and there may be damaging impacts in the meantime to the business’s rescue plans and routine procedures (e.g. paying wages).

Cash flow is also equally important in the UK’s other formal rescue procedures - Company Voluntary Arrangements and Schemes of Arrangement. Unlike administration, these procedures do not benefit from an automatic moratorium in the period in which they are being put in place¹, which leaves them open to the damaging consequences of an EAPO on their rescue prospects.

¹ Other than the little used small company moratorium pre-CVA in Schedule A1 to Insolvency Act 1986

The Regulation should ensure that EAPOs cannot be granted to a business that is in any collective insolvency proceeding as set out in the European Insolvency Regulation. The existing wording is insufficient to protect formal rescue procedures from the drastic consequences of EAPOs.

5. Creditor rights: We are extremely concerned about the interaction of the proposed Regulation with existing insolvency legislation. The Regulation does not specify the rights of the EAPO applicant vis-à-vis other creditors.

There is a strict order of priority in UK insolvency legislation that details the order in which creditor classes must be paid. The EAPO gives a creditor the right to freeze a sum of money, but are they then entitled to that money in priority to other creditors? Article 33 does not provide sufficient explanation or protection.

If priority is conferred on the applicant, the impact on the financial markets and lending climate would be extensive. According to research by the Centre for Economics and Business Research, *“the insolvency industry in the UK plays a vital role in maintaining a business environment in which creditors are willing to lend, entrepreneurship is encouraged and the economy can flourish. Our research demonstrates that jurisdictions, like the UK, that treat creditors appropriately in times of business difficulties are the most likely to be prosperous in the longer-term”*. Lenders’ willingness to lend is dependent on their confidence that their security will hold firm in the event of insolvency. Conferring priority on an EAPO applicant ahead of existing creditors may therefore discourage lenders from lending in the future.

The English insolvency system is currently based on the *pari passu* principle within creditor classes - i.e. creditors of the same class rank equally. To confer priority on an EAPO applicant would take a system that is fair (treating creditors in accordance with the security they hold and otherwise equally) and make it unfair (giving one creditor preferential treatment at the expense of the others). Even without changing the order of priority, EAPOs still impact negatively on the principles of insolvency legislation. UK insolvency legislation focuses on the collective - serving and protecting the interests of creditors as a whole. In contrast, EAPOs enable a *single* (perhaps vexatious) creditor to destroy attempts at business rescue that would benefit creditors as a collective.

6. Nominee accounts: Article 29 focuses on the preservation of joint and nominee accounts - those held on trust on behalf of a third party. According to this article, the amounts in these accounts “may be preserved to the extent that they are able to be preserved under the rules of national law governing the account”. To protect funds of third parties from creditors’ reach, it should be absolutely clear in the Regulation that nominee accounts are not available to an EAPO applicant.
7. Revocation: Under the proposed Regulation, the onus is on the defendant to apply for a review if they believe the EAPO was incorrectly made. This process could take up to 30 days;

during which time the defendant would not have access to the funds specified under the EAPO. The time lag for review but near-immediate enforcement of the EAPO risks severely damaging the financial position of the individual or business affected, perhaps irrevocably.

8. Compensation: The stated safeguard in the Regulation to protect defendants in cases where the EAPO is set aside is that the Court may require a claimant to provide a security deposit or equivalent assurance to compensate the defendant for any damage suffered. However, given the EAPO comes into force immediately while a review to rescind it can take 30 days, the damage to a business or individual would have already taken place and no amount of compensation will be adequate.

It is also entirely possible that the granting Court does not require a security deposit from the claimant. This contrasts to the UK freezing injunction, where the applicant has to provide undertaking in damages. Although this protection is therefore common practice in the UK, there is no guarantee that it is the case elsewhere. In Member States where undertakings in damages are not routine, a defendant's financial position could be damaged severely and perhaps irrevocably by the granting of an EAPO. The providing of a security deposit should be an essential requirement in every case, regardless of jurisdiction.

9. Exemption: Article 32 states that "where the law of the Member State of enforcement so provides, the amounts necessary, to ensure the livelihood of the defendant and his family, or to ensure the possibility to pursue a normal course of business, where the defendant is a legal person, shall be exempt from the enforcement of the order".

It is up to Member States to inform the Commission of the amounts they believe should be exempt (e.g. enough money to pay for food and shelter; or to allow a business to continue to function). The granting Court will presumably select from a list or table providing the requisite amounts that a defendant may retain in each case. If the defendant believes the amount specified for their circumstances is insufficient for their basic needs, they must apply to Court. This process can take up to 30 days - a period in which significant damage can be done to personal or corporate finances; again sometimes irrevocably.

10. Location of the Court: The Regulation stipulates that an applicant can apply to a court in their own jurisdiction to freeze a sum in a bank account located in another jurisdiction. Although this is intended to make the process as accessible as possible for the applying creditor, it means that those affected most by the asset - namely the business it belongs to and the creditor with security over it - will have to apply to a court outside their jurisdiction to rescind the order. This seems inequitable given the ease with which an EAPO can be granted and the perhaps natural sympathies of a court where a creditor is based as against a 'debtor' company elsewhere. It would be preferable to have to apply for an EAPO to a court in the jurisdiction in which the asset is based, or at least for the most involved parties to be able to challenge the EAPO in their own jurisdiction.

The Regulation states that businesses subject to an EAPO must apply to the Court in which the EAPO was made if they wish to apply for it to be set aside. Consumers, however, can

apply to a Court in their own Member State. This provision has been built in to protect consumers, which must be predicated on the notion that applying to a Court in another Member State is more difficult or disadvantageous. It is hard to see why a consumer deserves the protection of being able to apply to a Court in their own Member State, while a business is forced to apply to one in another jurisdiction.

11. Neutral effect on cross border trading: The Commission seeks to promote cross-border trading, but the introduction of EAPOs may create a disincentive to cross border trading - i.e. while creditors may feel more assured by their ability to apply for an EAPO, the 'debtor' company may be discouraged from trading due to fear of an EAPO (which would not exist were they to trade within their domestic market).
12. Abolition of the exequatur: The abolition of the exequatur is extremely unwise bearing in mind the concerns outlined above. It is imperative that the British courts retain their ability to protect individuals and businesses within their jurisdiction.

Addendum:

Following discussion with the Ministry of Justice, we understand that the wording of Article 7 may be revised.

The new wording would therefore read: the court must be satisfied "that the claim against the defendant appears to be well founded and that without the issue of the order the subsequent enforcement of an existent or future title against the defendant is likely to be impeded or made substantially more difficult because there is the real risk that the defendant might remove, dispose of or conceal assets held in the bank account or accounts to be preserved". In altering the wording in this way, and precluding the granting of EAPOs on grounds other than the risk of asset dissipation, the EAPO becomes more similar to the English 'freezing order'.

This is a positive development, but we are concerned that other crucial aspects of the 'freezing order' remain absent:

- Under the Regulation, an applicant for an EAPO may or may not be asked for a security deposit - the court has discretion. By contrast, the English 'freezing order' requires the applicant to provide an undertaking in damages. If the introduction of EAPOs is to be no more damaging to the rescue culture than the existence of freezing orders, it is crucial that an applicant always has to provide a security deposit when applying for an EAPO. This will help to deter vexatious applications and mitigate against any damages in the event the order is revoked.
- Even with the revised Article 7, the Regulation does not include a duty on the claimant to provide full and frank disclosure of all material when applying for an EAPO. This differs from the 'freezing injunction' where a claimant has a duty to provide all material facts to the Court. Without a disclosure requirement, there is a danger that claimants can present their case in a way they consider gives them the best chance of securing an EAPO, without fear of

penalty. By advantaging the creditor in this way, the EAPO distorts the carefully crafted debtor-creditor balance.

Even if Article 7 is amended, there is a danger that steps taken as part of a legitimate restructuring may be misinterpreted as the dissipation of assets under Article 7 1 (b)'s "risk that the defendant might remove, dispose or conceal assets held in the bank account". For instance, moving monies from accounts or holding money in an account separate to the company's ordinary bank account are actions that can be taken as part of the restructuring process. Unless the wording of the Regulation is sufficiently revised, these legitimate and worthwhile actions may be misconstrued as attempts to put assets beyond the reach of creditors or otherwise conceal them - grounds for granting an EAPO, the granting of which would devastate attempted rescue of the business.

In order to protect the ability of Insolvency Practitioners and other professionals to rescue businesses through pre-insolvency advice, actions taken in a restructuring, formal or informal, would have to be protected from Article 7 1 (b). If the UK Government intends to opt into a revised version of the EAPO Regulation, R3 is keen to work with the Ministry of Justice to produce a form of words that would prevent restructuring actions being unintentionally caught by this provision.

It should be noted that our concerns over the impact on formal rescue procedures and creditors rights remain relevant even if Article 7 is revised as the Ministry of Justice have suggested. To resolve this concern, the Regulation should ensure that EAPOs cannot be granted to a business that is in any collective insolvency proceeding as set out in the European Insolvency Regulation and the Regulation should specify that the granting of an EAPO will not confer priority on the applicant.

Q3 Do you agree with the impact assessment? If not, please explain why.

Given the limited time available for consultation, we have not been able to consider the Impact Assessment. We would be happy to offer further consideration were more time provided.

Q4 Are there any other specific comments you may wish to make?

No.