

# International Corporate Rescue



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### **Lehman Decision Results in Practical Difficulties for Administrators: *Lehman Brothers International (Europe) (In Administration) sub nom (1) CRC Credit Fund Ltd & Others* [2010] EWCA Civ 917**

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#### **Introduction**

On 2 August 2010 the Court of Appeal overturned the High Court decision in *Lehman Brothers International (Europe) (in administration) v CRC Credit Fund & 8 Others*<sup>1</sup> on two significant issues. The case concerned the segregation of client money by Lehman Brothers International Europe (‘LBIE’) (an English company) at the date of its entry into administration. A key question was what money should be classed as client money to be distributed to the former clients of LBIE by the joint administrators. Arden J, in her decision in the Court of Appeal, considered the ruling by Briggs J in the High Court to be a masterful and comprehensive judgment regarding the issues surrounding the distribution of client money. This case note examines how the ruling of Briggs J was overturned on two key points and the impact it may have on the treatment of claims by former clients of LBIE.

The joint administrators (amongst others) have made an application to the Supreme Court seeking permission to appeal this most recent decision as it presents them with a number of practical difficulties. At the date of writing no date has been set for the Supreme Court to consider the application for appeal.

#### **Facts**

LBIE was the principal trading subsidiary of Lehman Brothers Holding Inc. (‘LBHI’), a United States bank. LBIE held substantial amounts of money on behalf of its clients and its business was regulated by the Financial Services Authority (‘FSA’). The money held was subject to a statutory trust imposed by Chapter 7 of the Client Asset Sourcebook (‘CASS7’) (issued by the FSA pursuant to s. 139 of Financial Services and Markets Act 2000 (‘FSMA 2000’)). CASS7 is a set of statutory

rules for market participants and is designed to protect investors.

LBIE provided investment services for clients using the ‘alternative approach’, permitted under CASS7, for the handling of client money. Under this approach client money was initially deposited into the house accounts of LBIE instead of being directly deposited into segregated client accounts. LBIE would then segregate the money into the client accounts each day according to a reconciliation of client monies conducted at the close of business on the preceding day. This gave LBIE the ability, where appropriate, to net out a client’s positive and negative balances.

LBIE’s last segregation of client money into clients’ segregated accounts occurred on 12 September 2008, three days before the appointment of the joint administrators. This meant that substantial amounts of money deposited with LBIE on 13 and 14 September 2008 were not segregated and remained in LBIE’s house accounts. On 15 September 2008 joint administrators were appointed to LBIE under the Insolvency Act 1986 (as amended). This appointment triggered a ‘primary pooling event’ (the ‘Primary Pooling Event’) under CASS7 creating a client money pool (the ‘Client Money Pool’) under CASS7.9.6R. This Client Money Pool comprises all money deemed to be client money to be distributed to the former clients of LBIE by the joint administrators. The main issue raised in the High Court was whether the money that had been received by LBIE on 13 and 14 September 2008 and not segregated should form part of the Client Money Pool.

#### **High Court decision**

In the High Court Briggs J concluded that CASS7 imposed a statutory trust on the monies that LBIE received from or for its clients as soon as they were received.

#### **Notes**

<sup>1</sup> *Lehman Brothers International (Europe) (in administration) v CRC Credit Fund & 8 Others* [2009] EWHC 3228 (Ch).

Briggs J was of the opinion that the Client Money Pool could only comprise of the money that had been deposited in the segregated client accounts. Briggs J held that clients whose assets should have been segregated by LBIE, but were not, had no claim to the segregated assets. This decision presented the administrators with a straightforward way of identifying what assets should be considered as coming within the Client Money Pool.

LBHI, CRC Credit Fund, Lehman Brothers Finance AG and Lehman Brothers Inc appealed this decision.

## Court of Appeal decision

The Court of Appeal considered the objectives of the European Parliament and Council Directive (EC) 2004/39 (on Markets in Financial Instruments) ('MiFID') and Commission Directive 2006/73 ('MiFID Implementing Directive').

One of the main purposes of CASS7 is to protect client money and prevent an investment firm, such as LBIE, using client monies for their own purposes. This purpose is consistent with article 13(8) of MiFID and article 16(2) of the MiFID Implementing Directive.

The appeal was allowed in part:

*(i) Whether the statutory trust over client monies was imposed on receipt of the monies by LBIE or upon segregation into the client accounts.*

CASS7.7.2R should be read as creating a trust on receipt of client money by a firm, and further to that, CASS7.7.1G provided that the statutory trust created a relationship under which client money was in the legal ownership of the firm but remained in the beneficial ownership of the client. In all the circumstances the Court of Appeal held that the judge at first instance had been correct in his conclusion, CASS7 applied to all client money not just that which had been segregated.

*(ii) Whether the client monies to be pooled at the Primary Pooling Event were confined to those monies in the segregated accounts or all the client monies including those in LBIE's house accounts.*

The court held that the interpretation of the expression 'client money account' at CASS 7.9.6 had to be allowed a wide interpretation given the objective of both CASS7 and the MiFID directives. The expression could not be limited to segregated accounts as this would create a disparity between those firms operating the 'alternative approach' (referred to above) and those operating the normal approach to the segregation of client monies. The Court held that the Client Money Pool should include not only money from segregated accounts but also all identifiable client money in LBIE's accounts.

This interpretation was different from that of first instance where the Client Money Pool was considered to be confined to the monies in segregated accounts.

*(iii) Whether pooled monies should be distributed on a claims basis or contributory basis.*

The Court of Appeal held that all clients whose monies were pooled had a share in the Client Money Pool. The pool should be distributed on a claims basis not a contributions basis, thus each client was entitled to the amount which ought to have been segregated for them rather than the amount that was actually segregated for them. This differed from the High Court decision where Briggs J held that only those clients for whom LBIE had segregated client money prior to administration were entitled to claim against the pool.

*(iv) When did the money which the firm owed to the client become client money.*

The Court held that client money did not include sums due and payable by LBIE to its clients but not yet appropriated for that purpose. This was consistent with the decision at first instance.

## Lehman Brothers Bankhaus AG ('Bankhaus')

Although the Court of Appeal decision has widened the definition of client money thereby, in theory, increasing the size of the Client Money Pool, it is likely there will be a significant shortfall for creditors. This is not helped by a recent decision in the Frankfurt am Main Regional Court in Germany.

LBIE placed around USD 1 billion of client money in Bankhaus in Germany. When LBHI went into administration the administrators of Bankhaus refused to return the client money to LBIE as per the joint administrators' request. The joint administrators of LBIE then petitioned the Frankfurt am Main Regional Court on 22 December 2009 for an order for the Bankhaus administrators to return the money to the joint administrators of LBIE. On 7 October 2010 the Frankfurt court dismissed the petition of the joint administrators of LBIE thereby leaving the Client Money Pool short of USD 1 billion.

Whilst the joint administrators of LBIE are expected to appeal they will not be in a position to do this until they have received the written grounds for the judgment.

## Commentary

The decision of the Court of Appeal will mean that the process of distributing the assets from the Client Money Pool will be much slower. The joint administrators must now examine all LBIE house accounts for client money, a process that will likely require further directions from court regarding the methodology to be used. Clients can expect that the recovery of their money will now take substantially longer than previously envisaged. In short, the job of the Administrators has been made a lot more difficult in practical terms.

The decision has cast the client money net wider allowing more parties to pursue claims without the need to resort to the complexities of equitable tracing. In circumstances where client money has been commingled with LBIE's own money, tracing may be difficult, leaving a claimant with little option but to prove as an unsecured creditor.

Whilst the decision is of benefit to those clients whose money had not been segregated (although should have been) it is a blow to those clients whose money had in fact been segregated. Under the ruling of Briggs J there was a practical way to identify the clients entitled to claim from the Client Money Pool. The Court of Appeal decision will lead to an increased number of claims on the Client Money Pool, which when coupled with the Bankhaus decision may mean that there is an even greater shortfall in the Client Money Pool than previously expected.

Unsecured creditors will find that the pool of money from which they are claiming has now become smaller as client money in LBIE's house accounts is identified as being part of the Client Money Pool.

The judgment has alleviated some of the concerns associated with the 'alternative approach' to the

segregation of client money under CASS 7. Clients for whom client money was placed into a firm's house accounts but which was not segregated will not now be denied the protection of the statutory trust according to this decision.

## What next?

As stated above the joint administrators have applied to the Supreme Court for leave to appeal. They have based the reasons for seeking the appeal on the following:<sup>2</sup>

- The Court of Appeal recognised that the issues in question raise difficult, important and arguable points of law.
- The consequence of the Court of Appeal's decision is that, contrary to the objectives of the CASS distribution rules, the joint administrators will not be able to make a timely return of client money. Instead, prior to making any meaningful distribution from the client money pool, the joint administrators will have to embark on an exercise that will involve identifying entitlements to client money.
- The Court of Appeal's judgment also requires the joint administrators to trace identifiable client money to add to the client money pool.
- The joint administrators believe that such consequences could not have been intended by CASS and MiFID, and that the correctness of the judgment should therefore be tested by the Supreme Court.
- Finally, the joint administrators are troubled by the potential impact of the Court of Appeal's decision on the general estate.

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### Notes

2 <[www.pwc.co.uk/eng/issues/lehman\\_client\\_money\\_update\\_270910.html](http://www.pwc.co.uk/eng/issues/lehman_client_money_update_270910.html)>.

## **International Corporate Rescue**

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