

Client Money, Lehman Brothers International (Europe) Ltd, and the Global Trader Case

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The High Court of England and Wales has delivered the first judgment on whether client money received by an entity regulated by the Financial Services Authority (the “FSA”) was protected by a statutory trust under the FSA’s Client Asset Rules (the “CASS Rules”)¹, in circumstances in which the money was not held in a segregated client account. Under the CASS Rules, a broker must promptly pay client money into such a segregated account. Many clients of Lehman Brothers International (Europe) Limited (“LBIE”) have discovered that, contrary to their expectations, their money was not so segregated. Accordingly, those clients hope to establish that they have either a proprietary claim to the money that had been segregated, or at least a share of the single “pool” of all client money that, under the CASS Rules, is created upon the failure of the firm.

In the Global Trader case², Sir Andrew Park held that where client money that should have been segregated was instead paid into a firm’s general bank account, such that the client’s money became no longer identifiable, it would be difficult to show that the client’s money was subject to the statutory trust unless they could trace their monies into the general fund. In the event of a failure of the firm³, clients in such position would therefore only have a claim against the firm as an unsecured creditor.

This decision is likely to have significant implications for clients of LBIE. Where money was held in a general LBIE bank account as opposed to a segregated client account, those clients would be likely only to have a claim as an unsecured creditor of LBIE and would therefore not be able to participate in the scheme of arrangement in respect of trust property, currently being considered by the administrators.

¹ In particular, CASS 4.2.3R in respect of client money received before 1 November 2007 and CASS 7.7.2R in respect of client money received on and after 1 November 2007.

² *Re Global Trader Europe Ltd (in liquidation)* [2009] EWHC 602 before Sir Andrew Park.

³ Defined in the Glossary to the FSA Handbook as “the appointment of a liquidator, receiver or administrator, or trustee in bankruptcy, or any equivalent procedure.”

Global Trader

Global Trader was a spread betting firm. As the counterparty to each contract entered into by its clients, Global Trader required each client to provide margin to cover potential losses. Global Trader went into administration on February 15, 2008 and into a creditors' voluntary liquidation on June 17, 2008. It was subject to claims from various classes of clients, who argued that they had a proprietary interest, created by statutory trust under the CASS Rules, over part of the general funds held by Global Trader.

Statutory trust unlikely to operate where client money is not segregated

Global Trader paid certain of the money received as margin into its own general bank account and used that money for its own business purposes. The directors of Global Trader thought that they were entitled to do so as they mistakenly believed that clients had been "opted out" from the protections of CASS Rules.⁴ As a result, they believed, wrongly, that they were therefore not required to segregate such clients' money.

The High Court held that at the time such money had been received by Global Trader, it was client money and subject to the protection of the statutory trust under the CASS Rules, so long as the money was still identifiable. However, because the money was then paid into Global Trader's general bank account and used in the course of its business, it would be practically impossible to show that the clients' money continued to have a specific existence and identity. A client must be able to trace its client money into money actually held by the firm upon appointment of the administrators. In respect of money paid in to Global Trader's general bank account, this was highly unlikely.⁵

No statutory trust over client profits arising upon closure of trading positions not paid into segregated accounts

The High Court also considered whether the statutory trust applied to money held in the Global Trader general bank account which represented profits to the client arising upon closure of a trading position. Such profits should have been paid into a segregated bank account or directly to the client.⁶ The High Court held that such money was not "held on behalf of" the client and therefore was not client money under the CASS Rules⁷ which could be the subject of the statutory trust. Giving limited meaning to the words "held on behalf of" as they appear in the relevant CASS Rules describing client money, Sir Andrew Park held that the profits held in the general bank

⁴ Under the opting out procedure set out in CASS 4.1.9R which was not continued subsequent to the amendment of the CASS rules on 1 November 2007.

⁵ At paragraph 91.

⁶ CASS 4.2.34R.

⁷ Under CASS 4.1.1R and CASS 7.2.1R.

account would only become client money and held on behalf of the client when paid into a segregated bank account. For so long as the money is not paid to the client or his segregated account, only a contractual debt from Global Trader to the client exists and the client will have to make a claim for repayment of the debt as an unsecured creditor of Global Trader.

No statutory trust claim for non-segregated clients over money held in segregated accounts for other clients

The clients whose money was not paid into segregated bank accounts also claimed that they had a right under the CASS Rules, in common with those clients whose money was paid into segregated bank accounts, to the pool of money contained in all segregated bank accounts. The High Court held that the non-segregated clients had no proprietary interest in the pool of segregated client money as the CASS Rules only require distribution of the pooled client money to the clients for whom that money is held: in this case, only the segregated clients.⁸

An implication of Sir Andrew Park's judgment on this issue is that it may be the case that if only part of a client's money had been deposited into a segregated account and the rest had been deposited into the firm's general bank account, the client could only claim to have a proprietary interest over the amount of money paid into the segregated account in the distribution of the pool of segregated client money (i.e. he could not claim a proprietary interest in respect of the whole of his client money). An alternative (although possibly less likely) reading of the judgment would be that the client could claim for the whole sum, but that there would be a shortfall in his recovery by virtue of the fact that sufficient monies were not held.

Recovery by segregated clients may be limited by shortfalls in the segregated accounts at the commencement of the administration

A significant sum of money was in transit to a segregated account but had not yet reached it as at the time of appointment of the administrators. The Judge held that the liquidators were not able to remedy the error by a transfer of funds equal to the shortfall to the segregated account to the relevant segregated account after administration. The High Court also held that this sum in transit was not held on trust by Global Trader for the segregated client.⁹

LBIE Implications

If the Global Trader decision stands, it will have significant implications for LBIE clients who are currently seeking to recover client money held by LBIE when it went into administration. In particular, if the Global Trader case is followed, a statutory trust is not likely to arise in respect of:

⁸ CASS 7.9.6R and CASS 7.7.2R.

⁹ At paragraph 111.

- client money paid into a non-segregated bank account prior to LBIE entering into administration, unless the client money was paid in immediately before the appointment of the administrators and therefore may be sufficiently traceable for the continued protection of the statutory trust; and
- trading profits attributable to a client which were not paid into the client's segregated account.

In such circumstances, the client would rank as an unsecured creditor and would not be entitled to a share in the distribution of the pool of client money held in segregated accounts.

Although there is no appeal to be made in the Global Trader case (because of the limited assets and because the parties were all representative respondents), there is no doubt that the decision will form the basis of argument in the context of LBIE and is likely to be appealed to the Court of Appeal and above. The Global Trader decision was premised on the application of general trust law principles to the statutory trust created by the CASS Rules. However, a strong policy argument exists that the application of orthodox trust rules should not apply to preclude the protection of client money intended under the CASS Rules where there has been a failure on the part of the firm to fulfill its obligations to segregate and deal with client money properly.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Banking and Financial Institutions in the "Practices" section of our website (<http://www.clearygottlieb.com>) if you have any questions.

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