

Memorandum on the Lehman Client Money Judgment

Introduction

On February 29, 2012, the Supreme Court of England and Wales handed down the long-awaited judgment on a number of issues relating to the “client money” status of certain sums held by Lehman Brothers’ UK entity and claims against those sums. The appeal arose in the broader context of the Lehman Brothers administration, but specifically concerned Lehman Brothers International Europe (“LBIE”), the group’s main trading company based in London. The issues at stake in the appeal were the status of money that should have been segregated and held on trust for clients, but was not, the size of the “pool” of client money in which all those with client money claims would share and the extent of those claims themselves.

Background

The appeal concerned the interpretation and effect of chapter 7 of the FSA’s Client Assets Sourcebook (“CASS 7”). CASS 7 provides two separate approaches to handling client money: the “normal” approach and the “alternative” approach. Ordinarily, under the normal approach, a firm that receives client money should pay it into a client bank account promptly or at least within one business day.

Under the alternative approach, client money is received into, and paid out of, a firm’s “house” bank account. Subsequently, a reconciliation exercise is performed to adjust the balance held in the firm’s client account and then segregate an appropriate sum in the client account to identify it as belonging to a particular client. The alternative approach is designed for firms for whom the normal approach would be unduly burdensome, and who are deemed to have sufficient systems and controls in place to perform the requisite reconciliation exercise. LBIE was operating under the alternative approach.

CASS 7 provides that client money is held on a statutory trust by the firm for the benefit of the particular client. Money and assets subject to a trust do not form part of a debtor’s insolvent estate, meaning that a client should be in a better position than other unsecured creditors. Upon the insolvency of a firm in possession of client money (a “primary pooling event” or “PPE”), client money held in the firm’s client account is considered to be “pooled” for the collective benefit of the firm’s clients (a “primary pool”). The primary pool is then distributed *pari passu* to all eligible clients. Assets in the primary pool are therefore protected from the claims of other unsecured creditors.

In the Lehman insolvency, three factors disrupted the smooth operation of the primary pooling mechanism:

- (i) LBIE's failure to properly identify large amounts of client money upon receipt;
- (ii) LBIE's failure to segregate significant amounts of client money; and
- (iii) the insolvency of one of LBIE's affiliates, Lehman Brothers Bankhaus AG, which at the time of LBIE's insolvency was holding roughly half of the client money segregated by LBIE.

The Court noted that the most significant group of clients whose money LBIE had failed to segregate was its own affiliates, including the parent entity, Lehman Brothers Holdings Inc. The affiliates had advanced claims against LBIE exceeding US\$3 billion.

The Issues

The facts gave rise to three issues:

- (i) *The statutory trust issue*: when does the statutory trust arise – at the time of receipt of client money, or at the time of segregation of client money?
- (ii) *The primary pooling issue*: does client money held in a firm's house accounts form part of the primary pool?
- (iii) *The participation issue*: is a client's participation in the primary pooling arrangements dependent on the prior segregation of client money belonging to that client by the firm? Or is a client whose money ought to have been so segregated, but was not, also entitled to participate in the pool?

The Decision

- (i) *The statutory trust issue*

The Court was unanimous in deciding that the statutory trust arises at the time of receipt of client money, and not at the time of segregation. The Court noted that the latter interpretation would result in a client losing beneficial ownership of the funds upon receipt of them by the firm, only for the funds to once again become the client's property upon segregation. The judgment described this as "unnatural" and contrary to the objectives of the Markets in Financial Instruments Directive. Accordingly, client money is protected in insolvency whether or not it has been segregated.

(ii) *The primary pooling issue*

The Court (by majority) decided the primary pooling issue on the wording of CASS 7, as opposed to general principles of English trust law. The Court placed significant emphasis on what it termed the “general scheme” of CASS 7, namely, the protection of all client money received prior to a PPE. Where there is a choice of possible interpretations of the client money rules, the Court favored the interpretation that affords a high degree of protection for all clients. As the linguistic interpretation of the client money rules was not conclusive on the primary pooling issue, the Court ruled that client money held in a firm’s house accounts does form part of the primary pool.

(ii) *The participation issue*

As with the primary pooling issue, the Court sought to resolve the participation issue in a way which afforded protection to all of a firm’s clients on behalf of whom the firm holds funds. As a result, the Court (by majority) ruled that to exclude clients with identifiable claims to client money from the primary pooling arrangements would offend this principle, as it would discriminate in the levels of protection provided to clients based on whether or not the firm has segregated a particular client’s money. The Court described such a result as “arbitrary”. The Court therefore held that creditors with claims to client money would be eligible to participate in the primary pooling arrangements along with creditors whose money was actually held in client accounts.

Practical Implications

The decision is likely to have a substantial impact on the ongoing Lehman administration proceedings, as well as for administrations generally. A natural consequence of the ruling on the participation issue is that the number of clients having a claim against the pool will increase significantly. This is particularly significant given the US\$3 billion client money claim advanced by LBIE’s affiliates against LBIE in relation to funds which were not segregated by LBIE. The judgment confirms that the LBIE affiliates’ claims are valid client money claims under CASS 7.

As a consequence of the likely increase in claims, clients with claims against the LBIE primary pool are likely to receive a shortfall on any eventual distribution. Such creditors may seek other targets from whom to recover this shortfall.

Although the judgment is likely to result in a further delay in the resolution of the Lehman proceedings as the administrators seek to identify client money in the LBIE house accounts, now that the uncertainty in the interpretation of CASS 7 has been resolved, the decision may facilitate the more expeditious resolution of future insolvencies of financial institutions.

In particular, aside from an interim distribution based on conservative assumptions of the client money pool and the number of claimants, the Special Administration of MF Global UK Limited (“MF Global”) had been stayed pending the outcome of the Lehman judgment. Now that the correct interpretation of CASS 7 has been confirmed by the Court, the distributions to creditors of MF Global should take place within a short time period.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS

12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW

Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE

Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME

Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN

Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG

Bank of China Tower
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING

Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES

CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO

Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299