

UK Court of Appeal Rules on Lehman “Client Money”

Introduction

Under the FSA Client Asset Sourcebook (“CASS”), “client money” must be segregated, and is subject to a protective statutory trust. In the case of a large number of clients, Lehman Brothers International (Europe) (“LBIE”) failed to segregate client money. Accordingly, its administrators applied to the High Court seeking directions on the firm’s obligations in administration in relation to the distribution of client money.

In two judgments handed down on December 15, 2009 and January 20, 2010, Briggs J held that a “primary pooling event” (under which all client money held by the firm is treated as falling within a single ‘pool’) had occurred upon the appointment of administrators. At this point in time, monies segregated on behalf of clients formed a client money pool (“CMP”) against which client money claimants were entitled to claim. Briggs J went on to consider (i) which of LBIE’s clients were entitled to claim against the CMP and (ii) whether client money in unsegregated accounts should be added to the CMP.

In answer to the first question, Briggs J held that clients whose client money had not been segregated by LBIE at the time of administration had no claim against the CMP and were therefore reduced to the status of unsecured creditors of LBIE. Neither did the CASS rules require LBIE to include identifiable client money being held in unsegregated accounts within the CMP. This conclusion adversely affected, in particular, unsegregated client money claimants who became mere unsecured creditors with very uncertain prospects of recovery. Appeals against the judgment were launched immediately.

Appeal

On 2 August 2010, the Court of Appeal (composed of the Master of the Rolls, Lady Justice Arden and Sir Mark Walker) handed down judgment, upholding the appeal in two important respects. The Court of Appeal considered four issues, each of which is addressed in turn below.

Issue 1: Does CASS operate to create a trust on receipt, or a trust on segregation?

The Court of Appeal upheld Briggs J’s conclusion that CASS operates to create a trust on receipt. The Court held that the Markets in Financial Instruments Directive (“MiFID”) requires protection of client money on receipt of the funds, and that the

relevant CASS rule, which specifies that the firm “receives and holds” money as trustee, achieves compliance with that requirement¹.

Issue 2: Does CASS 7 pool identifiable money wherever found or only segregated client money?

Allowing the appeal, the Court noted that although CASS refers to “client money accounts”², it does not provide a definition of that term. The Court of Appeal examined the term, and found it significant that neither “client account” nor “segregated client account” were used in its stead. The Court of Appeal also found that the statutory trust created on behalf of clients by the CASS rules (and in particular the ‘pooling’ mechanism) is a single trust subject to a number of client money claims, rather than several individual trusts in favor of individual clients. The Court noted the fact that CASS speaks in terms of a pooling of “all the client money, in every type of client money account”³. Taking these various factors into consideration, it held that all client money, “in whatever account it is found” should form part of the CMP.

Issue 3: Do clients participate in the pool if they have claims to client money, or only if they contributed to the pool?

For those whose client money had not been segregated, this was the most important issue. Briggs J had found that CASS requires a ‘contribution’ basis of distribution: that is, clients whose funds were not segregated would not be entitled to claim against the CMP as their funds had never been part of the pool. Overturning that conclusion, the Court of Appeal held that while “MiFID does not directly confront the issue ... it is implicit in safeguarding the assets of clients that the clients should all share in the remaining assets.” The Court of Appeal’s reasoning is premised on the conclusion that “the FSA as regulator would seek to ensure that the rules ensured investment protection even where mistakes were made”. The Court of Appeal also concluded that the relevant statutory provision⁴ was sufficiently broad to require that any identifiable client money held in house accounts should be brought into the CMP.

Issue 4: When does money which the firm owes to a client become client money?

Briggs J held that client money did not include monies which the firm simply owes to the client by virtue of it having become payable: for example in relation to the payment of a ‘manufactured’ dividend that a LBIE may have been obliged to pay under as the result of a stock lending transaction. The Court of Appeal held that it was impossible for a trust to be created over property which was not yet in existence, and upheld Briggs J on this point.

¹ CASS 7.7.2.R

² CASS 7.9.6R

³ CASS 7.9.6.3G

⁴ section 139(1)(a), Financial Services and Markets Act 2000.

Conclusion

The effect of the judgment is to increase significantly the number of claimants against the CMP. It is unclear whether adding identifiable client money held in house accounts to the CMP will have a significant impact on the size of the pool. The unsegregated client money claimants are likely to include certain of LBIE's affiliates, which have been reported to have made claims totaling US\$3,000,000,000 against LBIE. The CMP has previously been valued at approximately US\$2,100,000,000.⁵

It is likely that a number of the client money claimants will appeal the judgment to the Supreme Court. The uncertainty in relation to claims in respect of client money will accordingly continue for some time.

Regulatory developments

In the wake of the collapse of Lehman Brothers, the FSA has consulted on measures designed to enhance protection of client money and assets⁶. The FSA proposed several measures which include: creating a requirement that all prime brokerage agreements contain a disclosure annex explaining the contractual limits on re-hypothecation; increased reporting requirements on client money and assets to all prime brokerage clients; restricting the placement of client money deposits within a group in order to reduce client exposure to group credit risk; prohibiting the use of general liens over client money held pursuant to custodial agreements; creating a new controlled function with specific responsibility for client money and assets; and introducing a monthly requirement for prime brokers to file a client money and asset return. The FSA has stated that it intends to follow this consultation with a policy paper in the third quarter of 2010. The FSA will also implement further consultation papers on title transfer arrangements and will publish another consultation paper in September 2010 on the standard of auditing reporting pursuant to the CASS rules.

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For additional information, or if you have any questions, please feel free to contact any of your regular contacts at the firm.

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⁵ Administrators' third progress report, <http://tinyurl.com/ThirdProgressReportPwC>

⁶ <http://tinyurl.com/FSA-ClientMoney>

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