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Briefing note March 2012

Supreme Court decision on Lehman client money opens the door for recovery of unsegregated client assets

In the final chapter of protracted proceedings arising from the collapse of Lehman Brothers International (Europe) Limited ("LBIE"), the UK Supreme Court, interpreting Chapter 7 of the FSA's Client Assets Sourcebook ("CASS 7"), has ruled on what constitutes client money, and which monies are required to be returned in the event of the failure of a firm. Upholding the decision of the Court of Appeal, the court has held that client money is held on trust immediately upon receipt and that, in the event of a firm's failure, client money held in a firm's own accounts is available for return to clients, even if it has not been segregated.

CASS 7

Under CASS 7, LBIE was required to place monies received from clients into one or more accounts designated for the purpose of holding client money, to make adequate arrangements to safeguard clients' rights to money held in those accounts and to prevent the use by LBIE of those monies for its own purposes.

Given the complexity of its operations, LBIE purported to comply with these obligations using the "*alternative approach*" under CASS 7.4.14G, 7.4.18G and 7.4.19G. This approach involves the payment of monies by clients into a firm's ordinary (or "house") bank accounts, followed by a daily reconciliation and payments between the firm's house accounts and the designated client money accounts to ensure that the client accounts hold the correct amount.

Section 139(1) of the Financial Services and Markets Act 2000 and CASS 7.7.2R provide for client monies to be held under a statutory trust. In the event of the failure of a firm (referred to in CASS as a "*primary pooling event*"), CASS 7.9.6R provides for monies held on trust (after deduction of the costs of distribution) to be pooled and paid back to clients rateably according to their respective interests in that pool of monies.

The facts

On the morning of 15 September 2008, when it was placed into administration, LBIE recognised a segregation obligation in respect of approximately US$2.17 billion of client monies held by it. However, in reality, the amount of client monies held by it and which should have been segregated was far higher than that. For example, affiliates of LBIE have advanced client money claims in excess of US$3 billion, for which LBIE made no provision, and LBIE's treatment of some derivatives transactions was incorrect. The shortfall in client monies was magnified by LBIE's decision to deposit approximately US$1 billion with an affiliate entity (Lehman Brothers Bankhaus AG), which is also now insolvent.

The issues

The Supreme Court considered three specific issues:

- When the statutory trust under CASS 7.7.2R arises;
- Whether client money paid held in LBIE's house accounts should be pooled and returned to clients; and
- Whether the claims of clients whose monies had not been segregated by LBIE should share in the pool of assets to be returned to clients.

The statutory trust

Upholding the decisions of the High Court and Court of Appeal, the Supreme Court unanimously held that the statutory trust under CASS 7.7.2R arises immediately upon receipt of the funds by the firm.

Those clients whose funds had been segregated by LBIE prior to 15 September 2008 argued that, where firms adopt the "*alternative approach*" rather than the "*normal approach*", funds become subject to the statutory trust upon segregation as opposed to upon receipt, and that monies temporarily paid into a firm's house accounts "*swill around*" with firms' own funds until reconciliations are performed and balancing payments made to ensure that sufficient funds are segregated. Rejecting those arguments, the Court stated that instead funds paid by clients to firms using the "alternative approach" "*sink to the bottom*" and that firms, when using their house accounts for their own purposes, make withdrawals of their own funds before touching client monies, in accordance with normal principles of equity.

Pooling of client monies

Answering the second and third of the issues above, and again upholding the decision of the Court of Appeal (although not unanimously, as Lords Hope and Walker dissented), the Supreme Court held that all client monies are subject to the statutory trust and fall to be pooled and returned to clients upon the occurrence of a "*primary pooling event*".

The Court concluded, contrary to the view previously taken by the Court of Appeal, that the interpretation of CASS 7 does not depend upon the consideration of any general principles of trust law. Instead, it decided that CASS 7 should be interpreted purposively by reference to the language used and the policy imperative of ensuring consistent protection for all client monies which *should* have been segregated (the "*claims basis*"). It favoured this approach over what it perceived would be the arbitrary results which may flow from including segregated assets within the pool available for return to clients whilst excluding unsegregated assets (the "*contribution basis*").

Implications

The Supreme Court's determinations answer specific questions in relation to which monies paid to LBIE are required to be returned, and which of LBIE's clients who are still, over three years since the collapse of LBIE, seeking to salvage substantial sums from its administrators may receive a share of a relatively shallow pool of available assets. In addition to its obvious importance to them, the decision in this case may also (notwithstanding changes to some provisions of CASS 7 during the intervening time) be of significance for clients seeking to recoup monies paid to firms which have subsequently collapsed, most notably MF Global UK.

The administrators in that case, appointed under the FSA's Special Administration Regime, have been awaiting the Supreme Court's determination in relation to the position of its clients whose funds were not segregated at the time of its collapse. The effect of the decision is to broaden the number of claims on the client money pool by including all clients whose monies should have been segregated, whether or not they were in fact segregated. However, the decision also increases the pool of client monies by including monies not in segregated client accounts. However, identifying and recovering client monies that were not segregated will involve a complicated tracing and following process, assuming that it is possible at all, which may take a long period and require further visits to the courts.

By going beyond the general principles of trust law and finding that (a) participation in the client money pool is based on the "claims basis" and (b) all identifiable client money is to be treated as pooled and not only that which is segregated, firms can no longer assume that funds in a house account of a client who uses the alternative approach are proprietary funds and are not subject to client money protections.

This creates a number of uncertainties for firms:

- Is the right of set off that a firm has over proprietary funds passed up by a client applying the alternative approach still sound? Possibly, even though the first monies taken out of the house account for a client's own purpose are to be viewed as proprietary funds, client money may still be passed on. Further, it is not certain that the fact that a firm which had no actual notice of client money entitlements would be sufficient to defeat a claim if the firm "ought to have known" that the funds were client monies;
- Likewise, there is now uncertainty where a client passes up funds from its house account as margin to a firm and such margin is passed up to the exchange either because client money entitlements are not notified or because the firm as margin provider may not have the requisite title for some exchanges;
- Last, it goes without saying that administration becomes more complicated for firms to deal with as an administrator of a client will need to carry out a forensic exercise to retrieve client monies which may have been passed on.

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