The Lehman Brothers client money appeal judgment: We're all in it together

1. Background

Since 15 September 2008, the date Lehman Brothers International (Europe) ("LBIE") went into administration, LBIE's Administrators (PwC) have been grappling with the complicated task of working out how to distribute the client money held by LBIE at the point of its administration. This task has been made all the more difficult because LBIE had consistently failed to keep client money segregated from its own house funds, in spite of the FSA's client money rules (CASS 7) requiring it to do so, in its capacity as trustee of such client money. There was, therefore, a long-running deficit in the amount available in the client money pool, as compared to the amount that was required (and expected) to be segregated at any point in time under CASS 7. The FSA failed to spot this breach. Furthermore, one of the banks with which LBIE held US$1bn of client money for safekeeping, Lehman Brothers Bankhaus AG, has also become insolvent, thereby further increasing this deficit. In light of this 'double whammy', and in recognition that the answer to this problem lies in analysis of CASS 7 against the backdrop of UK trust and insolvency law and European law (specifically MiFID - the EU's Markets in Financial Instruments Directive), the Administrators have turned to the English courts for guidance.

In the first instance, the High Court delivered a judgment that provided an arguably straightforward answer for the Administrators, who would have (in summary) been required to include within the client money pool for distribution only those amounts that had been segregated by LBIE (ignoring the amounts that LBIE had failed to segregate), and distribute the pool amongst only the clients whose client money was actually contained within the pool (ignoring clients whose money was not segregated). Please refer to our previous article on the High Court judgment for more details (see here).

2. What were the conclusions of the Court of Appeal?

The Court of Appeal considered four key questions and concluded as follows:

1) The client money trust arises on receipt of any client money by a firm

This is in line with the High Court judgment. It means that a firm owes trustee duties to a client from the time at which the firm begins to hold such money on behalf of the client (which, in the case of payments from the client or a third party, will be the time of receipt).

This outcome is significant in the context of the FSA's 'alternative approach' to client money segregation. The alternative approach allows firms to receive client money into their own house accounts, and make appropriate adjustments (no later than the close of the next business day) to reconcile the difference between the amount that is in the client money bank accounts and the amount that it should have been segregating at the close of the previous business day. There is, therefore, an inherent inter-day risk that the firm may, contrary to its trustee requirements, dissipate the received client money before the relevant reconciliation takes place. The Court of Appeal judgment advocates the use of 'prudential buffers' to address this risk. A prudential buffer is a surplus amount that a firm maintains, either in its house account or client money account, to ensure at all times that it holds, as a trustee, the entire amount of client money that it is required to hold. The buffer is funded from the firm's own capital. At the moment, the use of any buffer is subject to a consultation process with the firm's auditors and the FSA. In future, if the alternative approach survives, the requirement to maintain a prudential buffer is likely to be codified.

A similar risk referred to above also arises where a firm goes into administration in between the point of receipt of client money and the firm's next scheduled reconciliation (which does not take place because of the commencement of the administration process). If the money that was not segregated proves to be untraceable, the claim for that money will effectively rank as an unsecured creditor claim (and not a proprietary one). The Court of Appeal judgment addresses this risk by simply requiring the Administrator to give effect to the final outstanding reconciliation.

2) The client money pool to be distributed on insolvency includes all traceable client money, wherever it may be

CASS 7 provides that, on the failure of the firm, all client money held by the firm is to be pooled for distribution. The Court of Appeal judgment overturns the High Court judgment on the point of what money should be pooled under this process.

The High Court judgment stated that the client money pool only included the client money that was held as such as at the time of administration (subject to a few permitted adjustments). The High Court judge was persuaded by the symmetry in requiring the firm to identify and segregate client money whilst in business, and then distribute the same amounts on failure. Clients whose client money was not properly segregated would still have a proprietary claim to the extent that their client money could be traced within LBIE's house accounts.

The Court of Appeal judges found this approach to be flawed. They were more persuaded by the argument that since there was only one single trust, the distribution in relation to that trust should include all the money that within it, under one single pooling.

This outcome creates forensic issues for the Administrators in terms of ascertaining the amount in the client money pool. Under the High Court judgment they would have only needed to include those amounts that were in LBIE's client money bank accounts, and in transaction accounts held with brokers and clearing houses (subject to some adjustments). Now under the Court of Appeal judgment they are potentially required not only to scour each and every account in which LBIE ever held client money (even momentarily) for any trace of this client money, but also to pursue all payments from those accounts (whether to other accounts or to third parties) to see how far the trail can be usefully followed. Trust law would lend a small hand in this process: to the extent that an account balance falls below the client money amount that it is meant to contain (or becomes overdrawn), there is no traceable client money interest in that difference (or none at all in the account), since a trust can only attach to identifiable property (and not to an overdraft). LBIE's own liquidity management process, in which surplus cash balances were constantly swept up to its parent company and paid back down to LBIE only as and when required, could also serve to destroy the trail. Nevertheless, such a process could be time-consuming, costly, and potentially make no net difference to the overall size of the client money pool. The Court of Appeal judges allude to the fact that a tracing exercise carried out on a collective (as opposed to individual) entitlement basis might be more fruitful, although this was not fully considered.

3) Any client who has a contractual entitlement to client money can participate in the distribution (pro rata)

Again, the Court of Appeal judgment overturns the High Court judgment, which on this point was naturally aligned to the issue of what was included in the client money pool.

Under the High Court judgment the clients entitled to a share in the pool were only those clients who had actually contributed to it (i.e. those that had some traceable proprietary claim to the money in the pool).

Under the Court of Appeal judgment, clients who did not necessarily have any proprietary claim to the client money pool could nevertheless potentially have a share in that pool based on a contractual claim. In other words, if LBIE was required as a matter of contract to segregate client money for them, then they could participate in the pool, even if their client money entitlement could not be traced to money that was actually within the pool. In reaching this conclusion, the Court of Appeal judges directly opposed the High Court judge in his analysis of the wording of CASS 7, in particular his interpretation of the phrase 'client money entitlement' (which the FSA unhelpfully omitted to define within CASS 7). Furthermore, the Court of Appeal judges argued that, under their approach, there is no need for the Administrators to make any final adjustments to the amount of the pool.

Consequently all clients are 'in it together' as regards the distribution of client money, irrespective of whether LBIE treated them as it should have done (by segregating their money) or did not. The value of the entitlements of clients whose money had been segregated is effectively diluted, as compared to the value of those entitlements under the High Court judgment (where the non-segregated clients could not participate in the client money pool). The 'pari passu' type arrangement that the CASS 7 distribution provisions purport to provide for is effectively guaranteed, and so the FSA may well feel vindicated. However, there are some important consequences of this outcome, which may not be so pleasing in terms of investor protection.

First, it means that any efforts made by an individual client to ensure that his client money is being dealt with in a compliant way could potentially be (for the most part) wasted energy if the firm fails to treat all its other clients in the same compliant way. In our previous article (see here) we suggested some sensible steps that a client might take, such including due diligence and increased vigilance over statements. These would have helped under the High Court judgment, but are arguably of limited use here with a non-compliant firm. A client who is diligent and pro-active may end up being no better than the client who does nothing.

In such circumstances, there is an increased importance on the firm's overall compliance with the CASS 7, and therefore the FSA's adequate oversight of such compliance. As the increasing number of client money enforcement cases shows, an investor may well be justified in feeling nervous, despite the FSA's strict new approach to CASS 7 compliance.

Secondly, the Appeal Court judgment allows clients of LBIE who were Lehman group affiliates (many of which are also in administration) to participate in the client money pool. Because LBIE carried out a significant amount of intra-group business, but failed to segregate any client money belonging to its affiliates, this will bring about a heavy dilution of the value of the entitlements of any non-affiliate clients. If those affiliates were dealing in their own capacity with LBIE, then on distribution of the LBIE client money pool those affiliates would receive an injection of cash assets, which would be available to satisfy any (non-client money) claims against them. Therefore, indirectly, the Court of Appeal judgment could potentially increase the amount of money available to unsecured creditors of the Lehman Brothers group as a whole, to the detriment of LBIE's non-affiliate clients.

Thirdly, the Administrators are given another forensic issue to deal with – how to identify the universe of clients that have a valid contractual entitlement that gives rise to a share in the client money pool, and how to value each of those individual entitlements to work out the size of each share in the pool.

The starting point for any contractual entitlement is, naturally, the terms of the contract. In the case of LBIE (and no doubt many other investment firms offering myriad prime brokerage and trading services), the contracts in use are often unclear and ambiguous. Particular types of problematic clauses may include title transfer collateral provisions, where money that would otherwise be client money is entirely transferred to the firm on the basis that it is collateral, and 'rights to use' provisions, where the firm has an option to use client money in the context of rehypothecation.

Aside from the construction of the contract, whether or not the performance of the contract gives rise to an entitlement to client money is a separate matter that relates, for example, to what exactly the transactions were, how big they were, and when they were settled. In the context of LBIE's administration this adds an additional layer of complexity.

4) Amounts owed by a firm to a client only become client money when segregated

This Court of Appeal decision is in line with the High Court judgment. The types of debt considered in this context included manufactured dividends under stock-lending agreements (with the client as the lender). The Court of Appeal's judgment means that pending a firm taking some sort of positive step towards discharging its debt to a client (such as transferring an appropriate amount to the firm's client bank account, or factoring in such debt into its reconciliation process), the debt is not crystallised as trust money. As such, on the failure of a firm, an undischarged debt does not fall to be counted in the client money pool - it is not a proprietary interest to which a trust can attach. Consequently, any outstanding debt claims rank as unsecured creditor claims on a firm's failure.

This does place some value in clients requiring a firm (for example by contract) to discharge any debts promptly (whether by direct payment or segregation) although, as above, the benefit of this may be counter-balanced by the firm's non-compliance with the segregation rules, whether generally or in respect of particular clients.

3. The approach taken by the Court of Appeal

Whilst both the High Court and Court of Appeal judgments both include a relatively high degree of textual analysis (breaking down specific provisions of CASS 7 and MiFID for example), the fact that they approach this exercise from different perspectives goes some way towards explaining the decisions described above, and their consequences.

Under the High Court judgment, MiFID was interpreted as mandating and harmonising purely organisational requirements, which the relevant authorities across the EEA (the FSA in the UK) were required to implement – there was no implicit or explicit legal safety net for clients created at the MiFID level. Under the Court of Appeal judgment, it was argued that because the MiFID client money provisions are concerned with safeguarding client assets, investor protection was an implicit intention of MiFID, and therefore its implementation in the UK (CASS 7) should be interpreted to give effect to this intention. Member States were, by implication, required to create an effective legal safety net – which is, for example, the purpose of the client money trust and distribution rules under CASS 7.

The High Court judgment also interpreted the client money rules as being drafted from a utopian perspective, in which very little regard was had to the consequences of a firm not complying with the regime. This prevented the High Court from recognising any additional protections for investors where CASS 7 fell short of explicitly providing these, and required the High Court to look to general law for solutions to the problems posed by CASS 7, as a supplement to the CASS 7 rules. The Court of Appeal took a different approach, taking the perspective that the FSA must have been concerned with the risk of firms breaching the regime, and therefore gave effect to those concerns, for example by seeking to not prejudice clients of a firm that took the alternative approach over clients of firms that took the normal approach, on the basis that the FSA could not have intended such a consequence.

Therefore, acknowledging from the outset that CASS 7 is designed to protect investors, the Court of Appeal sought to iron out the 'glitches' and 'legal black holes' that the High Court judgment could not satisfactorily address. For example, in respect of unapplied credits (segregated money which had not yet been allocated to a particular client) the High Court judgment would have required the Administrator to use LBIE's accounting records to ascertain (arguably subjectively) LBIE's intention as to which clients would be allocated such amounts. The Appeal Court judgment does not require this exercise to be undertaken, since the clients' contractual entitlements will determine their share of the pool.

Both judgments are sensitive to the principles of UK trust law and insolvency law, although the Court of Appeal is also purposive in this respect. For example, the approach taken in respect of trust law by the Court of Appeal was that "*trust law can be moulded to meet the requirements of the situation*" (para 68). This meant that the principles of trust law (such as the maxim: 'equality is equity') and remedies under trust law (such as tracing) can be purposively incorporated in a statutory trust regime which is otherwise relatively silent, to give effect to the overall purpose of that regime (investor protection). This, for example, allowed the client money pool to stretch beyond simply the amounts that had been compliantly segregated.

In terms of the practical consequences of the Court of Appeal judgment, in particular the delay in distribution that may result, and the dilution of the potential claims of the segregated clients (as compared to that under the High Court judgment), the Court of Appeal took the view that such consequences are more attributable to the circumstances of the case (myriad clients, accounts, breaches and transactions) than to the decision of the judges. The Court of Appeal sought the 'correct'

answer to the problem of dealing with a firm's failure where the alternative approach had been used in breach, rather than the most helpful answer in the circumstances of LBIE's failure.

In particular, the Court of Appeal judgment points out that this appeal was not about the claim of any particular client (for example in relation to the validity of a contractual entitlement, or tracing of their client money). Applying the conclusions that were reached by the Court of Appeal to a different firm's failure will naturally have different practical consequences depending on what has happened – these consequences may be complicated (as in the case of LBIE), but they could also potentially be very simple (for example in the case of a much smaller firm). However, when considering the complexity of LBIE's situation that the Administrators face, the Court of Appeal asserts (perhaps unhelpfully) that there is no evidence that the distribution of client money under the High Court judgment would be more timely and productive than under the Court of Appeal.

4. Where do we go next?

It is likely that permission to appeal against the Court of Appeal judgment will be sought, most probably by the segregated clients, whose share in the client money pool is now heavily diluted by the entitlements of unsegregated clients, most notably LBIE's affiliates. This seems all the more inevitable because the arguments in the judgment are very finely balanced. Indeed, as the Master of the Rolls, Lord Neuberger, points out in the context of the second question above, the court did not find outstandingly persuasive arguments on either side (para 223-224). If an appeal to the Supreme Court is permitted, this will clearly delay things further.

In any case, if the Court of Appeal judgment remains good law, or is upheld on appeal, the Administrators will need to assess its implications for the likely timing and level of any distribution, both in respect of client money and unsecured creditors. They may seek further directions from the courts as to what might be a workable solution in respect of the two forensic activities identified above, given that there is no limitation period under UK trust law (valid claims for breach of trust can be brought at any time after a distribution is made).

Against the backdrop of this case, the FSA's ongoing drive to make firms accountable to their client money breaches continues. To the extent that a firm has breached CASS 7 (however flawed it may be) the FSA will show zero tolerance. As has been shown from recent consultations, the FSA will also seek to rectify or improve its rules to the extent possible, given the potentially ongoing court process. This may include incorporating the prudential buffer as a requirement for firms using the alternative approach.

Finally, clients may be left in the unenviable position of needing to place their faith in the firms in which they deal with, and in the FSA for monitoring those firms' compliance with CASS 7. On the one hand, the overall effect of the Court of Appeal judgment is that the net of protection can be cast wider. Clients' rights under trust law will protect their interests within the operation of the CASS 7 distribution rules, so they do not need to carry out the tracing exercise themselves – subject, of course, to the extent that there remains identifiable property to which those rights can attach. On the other hand, the dilution of claims of clients whose client money had been properly segregated (as compared to the value of their claims under the High Court judgment) will seem unfair, particularly to those clients who go to extra lengths to obtain assurances through due diligence, or preferential contract terms to protect their client money, in circumstances where the firm in question is non-compliant in respect of all its other clients. It remains to be seen as to whether or not this judgment will have a net positive effect on investor confidence.

Please see here for the full text of the Court of Appeal judgment. If you would like to discuss the judgment in more detail, or have some concerns in relation to client money, please feel free to get in touch with your usual CMS contact.

The client assets and living wills page on our Regzone page (click here) contains more useful information relevant to this topic.

Contacts

Ash Saluja
Partner, Financial Services
T: +44 (0) 20 7367 2734
E: ash.saluja@cms-cmck.com

Mez Raja
Solicitor, Financial Services
T: +44 (0) 20 7367 2445
E: mez.raja@cms-cmck.com