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NO JURISDICTION FOR LEHMAN SCHEME DEALING WITH CLIENT ASSETS

By Ian McDonald and Kristy Zander

On 6 November 2009, the English Court of Appeal unanimously held that the Court did not have jurisdiction to sanction a scheme of arrangement proposed by the administrators of Lehman Brothers International (Europe) (LBIE) with respect to trust assets held by LBIE as trustee. This decision was of critical importance, not only to those whose assets are tied up in the LBIE estate, but also to depositors and others who rely on the sanctity of the English trust as a pillar of the English banking and financial system.

The facts

The essential element of an English trust, which is a legal concept dating back to the Crusades, is that whilst the trustee may be the holder of bare legal title to the assets, it is the beneficiary who is the beneficial owner of the assets. As such, assets held on trust do not form part of the trustee's estate available for distribution to ordinary unsecured creditors and must instead be returned to their rightful owner on demand.

At the time it went into administration on 15 September 2008, LBIE held assets on trust for clients, particularly for hedge fund clients through its prime brokerage business. As a part of that business, LBIE came to hold securities on trust for its clients, either as custodian or by holding positions on a charge basis as collateral. LBIE also held various property on trust for its affiliates across the world, as custodian or sub-custodian. In turn, those affiliates (which are in insolvency proceedings in their respective jurisdictions) may have held the assets on trust for their own clients.

Since the early days of the administration, the administrators of LBIE have encountered a number of challenges in identifying and returning trust property to its clients and affiliates. The administrators have recently estimated that LBIE is currently holding (directly or indirectly) up to approximately US$18.9 billion worth of trust assets, of which approximately US$11.4 billion is within the administrators' direct control. However, due in large part to the dismal state of the records kept by the Lehman Brothers companies, the administrators still do not have a clear picture of precisely what assets are held on trust, on what terms and for which client or clients. LBIE did not always hold the assets itself, but rather held them through third party and affiliated banks, custodians, agents, counterparties, exchanges and clearing houses and LBIE still does not have control of all of those assets. Some holdings of trust property were held subject to contractual security or set-off rights. In addition, it seems likely that there will be shortfalls in relation to some or all classes of assets on trust and the administrators face the daunting task of determining a method of distributing trust assets to their owners

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without exposing themselves to the risk of claims for breach of trust in the event of the subsequent emergence of competing claims to the assets.

To move matters forward, the administrators of LBIE proposed that a scheme of arrangement be implemented to effect a process for the distribution of the trust assets to their beneficial owners. A scheme of arrangement is an arrangement between a company and its creditors (or members) pursuant to the Companies Act 2006. It must be sanctioned by a 75 per cent majority of various classes of creditors, and by the Court. When effective, it binds all creditors (including those who did not vote in favour of the scheme).

The administrators originally sought leave from the Court to propose the scheme of arrangement to trust claimants. Counsel for the London Investment Banking Association appeared at the hearing to question whether the Court had jurisdiction to sanction such a scheme and the administrators subsequently sought directions from the Court in relation to the issue of jurisdiction. Mr Justice Blackburne decided, on 21 August 2009, that the Court did not have jurisdiction to sanction such a scheme. The administrators then appealed to the Court of Appeal.

The issue on appeal (as in the judgment at first instance) centred on whether a person for whom LBIE held assets on trust could be regarded as a 'creditor' and thus whether the proposed scheme of arrangement could apply to compromise proprietary claims against LBIE for the return of trust property held by LBIE as trustee.

The decision

The Court held that a person with a purely proprietary claim against a company is not its 'creditor'. Since 'creditor' is not defined in the Companies Act 2006, the Court gave effect to the ordinary conventional sense of the word 'creditor' as someone with a pecuniary claim against the company.

The administrators submitted, as they had done in the Court below, that trust claimants were 'creditors' insofar as they had a pecuniary claim against LBIE (for example, for damages for breach of trust). The administrators argued that once a person is a creditor, they can be caught by the scheme even in relation to non-pecuniary claims. The Court rejected that argument as being inconsistent with the intention of Parliament. The Court found that such a pecuniary claim is merely incidental to the trust claim and, in any event, the fact that someone is a creditor in connection with a different claim does not justify him being treated as a creditor for the purpose of the proprietary claim.

The administrators also sought to rely on authority to the effect that the Court has jurisdiction to sanction a scheme of arrangement affecting proprietary rights held by secured creditors. However, the Court distinguished the position of secured creditors (who, despite having security over property, hold that security only in their capacity as creditors of the company, only for so long as the underlying indebtedness continues and subject to the company's equity of redemption) from that of beneficiaries under a trust.

In addition, the administrators sought to rely on the decisions in *Re T&N Limited (No. 3)* [2006] EWHC 1447 and the Australian case of *Re Opes Prime Stockbroking Limited* [2009] FCAFC 125, in which it was held that schemes of arrangement can extend to release rights against third parties related to, and essential for the operation of, the scheme. Those decisions are not without controversy and, interestingly, both Lord Neuberger MR and Patten LJ indicated, *obiter dicta*, that they considered them to be correct. However, those decisions did not assist the administrators in this case.

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Implications

For those parties whose assets are tied up in the LBIE administration, the decision may result in the passing of further time (and the expenditure of additional costs) before the return of the assets. The administrators have indicated that they are considering alternative options for facilitating the return of trust assets.

The Court has recently made an order that a bar date of 19 March 2010 be set for trust claimants to lodge claims in relation to trust assets held by LBIE. This means that the administrators will be protected from breach of trust claims if, after that date, they distribute trust assets on the basis of information then available to them. In addition, the administrators have made a proposal to trust claimants inviting them to bind themselves voluntarily to a proposed contractual settlement. If effective, the settlement will be in similar terms to the proposed scheme of arrangement, except that those who do not agree to the settlement will not be bound by its terms. One of the conditions precedent to the proposal is that a high threshold (by value) of trust claimants sign up to its terms. Whether that threshold will be reached (and the settlement thereby become operational), and the effect of the settlement on those remaining trust claimants who do not sign up to it, remain to be seen.

In addition to the impact of the Court of Appeal's decision on those directly affected by the LBIE administration, the decision has important implications for the world of English trust law. The concept of an English trust, and the sanctity of assets held on trust, permeates England's legal and financial systems. The Court has shown its inclination to protect the trust concept and not to allow the interests of trust beneficiaries to be 'crammed down' by use of a scheme of arrangement. The comments made by certain of the Appeal judges supporting the concept that companies proposing schemes of arrangement can extend such schemes to release claims against third parties will also be of general interest to the restructuring community.

While the decision of the Court of Appeal will not have surprised many, it will be interesting to see, given the very significant complexities that the LBIE administrators face, whether their alternative proposals for dealing with trust assets meet with any success.