



29 February 2012

PRESS SUMMARY

In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2012] UKSC 6
On appeal from [2010] EWCA Civ 917

JUSTICES: Lord Hope (Deputy President), Lord Walker, Lord Clarke, Lord Dyson and Lord Collins

BACKGROUND TO THE APPEALS

This appeal arises from the insolvency and administration of the Lehman Brothers group of companies. Lehman Brothers International (Europe) (“LBIE”) was the principal European trading company in the group and is incorporated in England as an unlimited company with its head office in London. LBIE is authorised and regulated by the Financial Services Authority (“FSA”). Its ultimate holding company is Lehman Brothers Holdings Inc (“LBHI”), incorporated in Delaware and based in New York. LBHI is now in Chapter 11 bankruptcy. LBIE was put into administration by order of the High Court made before the opening of business (at 07.56am) on Monday 15 September 2008: [24]. Many difficulties have arisen in the administration and the administrators have made several applications to the Companies Court for directions. The application which gives rise to this appeal relates to the provisions governing client money, namely chapter 7 (Client money: MiFID business) of the Clients’ Assets Sourcebook issued by the FSA (“CASS 7”), made under the Financial Services and Markets Act 2000 (“FSMA”): [25]-[26].

CASS 7 provides for a ‘normal approach’ and an ‘alternative approach’ to discharging a firm’s client money segregation requirements. LBIE adopted the alternative approach. 7.4.16G of CASS 7, among other things, provides that “*Under the alternative approach, client money is received into and paid out of a firm’s own bank accounts... A firm that adopts the alternative approach will segregate client money into a client bank account on a daily basis, after having performed a reconciliation of records and accounts of the entitlement of each client for whom the firm holds client money with the records and accounts of the entitlement of each client for whom the firm holds in client bank account and client transactions accounts to determine what the client money requirement was at the close of the previous business day.*” CASS 7 (7.7.2R) further provides that “*A firm receives and holds client money as trustee (or in Scotland as agent)...*” Where the firm fails, this is known as a primary pooling event (“PPE”). 7.9.6R provides that “*If a primary pooling event occurs: (1) client money held in each client money account of the firm is treated as pooled; and (2) the firm must distribute that client money in accordance with CASS 7.7.2R, so that each client receives a sum which is rateable to the client money entitlement calculated in accordance with CASS 7.9.7R.*” A secondary pooling event occurs on the failure of a third party to which client money held by the firm has been transferred (7.9.14R). 7.9.13R provides that if both a primary pooling event and a secondary pooling event occur, the provisions relating to a primary pooling event are to apply: [44].

In an ideal world, the flawless operation of the scheme created by the CASS 7 rules would ensure that, upon a firm’s insolvency, the clients would receive back their money in full, free from the claims of the firm’s creditors. In the imperfect and highly complex real world occupied by LBIE and its numerous clients, there has been a falling short in the achievement of these objectives on a truly spectacular scale. This is a result of two prime causes: first, on the basis of the assumed facts, LBIE failed to identify as client money, and therefore also failed to segregate, vast sums received from or on behalf of a significant number of its clients; second is the failure of another LBIE affiliate, Lehman Brothers Bankhaus AG (“Bankhaus”) with which LBIE had deposited at least US\$1 billion of segregated client

money: [27]. Before the administration order, the last internal reconciliation of clients' funds took place on the morning of Friday 12 September 2008.

This appeal has proceeded on assumed facts and raises three issues concerning the true construction of CASS 7: (i) when does the statutory trust created by 7.7.2R arise; (ii) do the primary pooling arrangements apply to client money held in house accounts; and (iii) is participation in the notional client money pool ("CMP") dependant on actual segregation of client money? [128]

JUDGMENT

The Supreme Court dismisses the appeal by a majority (Lords Hope and Walker dissenting as to the second and third issues): the statutory trust under CASS7 arises on receipt of client money; the primary pooling arrangements apply to client money in house accounts; and, participation in the CMP is not dependant on the segregation of client money.

REASONS FOR THE JUDGMENT

As to when the statutory trust arises, the two competing answers are time of receipt and time of segregation of the funds. The Court unanimously holds that the trust arises at time of receipt. Where money is received from a client or from a third party on behalf of a client it would be unnatural, and contrary to the primary purpose of client protection, for the money to cease to be the client's property on receipt, and for it (or its substitute) to become his property again on segregation. It would also be contrary to the natural meaning of the comprehensive language of CASS 7.7.2R. Segregation without a trust would not achieve MiFID's objective whereas under the alternative approach an immediate trust of identifiable client money does provide protection: [62]-[63], [182]-[183]. Lord Hope further supports this conclusion on the basis that the same result would be obtained using the law of agency, as it is in Scots law: [7]-[14].

As to whether participation in the notional CMP is dependant on actual segregation of the client's money, the answer is to be found in the proper interpretation of CASS 7, in particular 7.9.6R, 7.9.7R and 7.7.2R: [139]. It does not depend on a consideration of any general principles of trust law: [145]. The general scheme of CASS 7 is that *all* client money is subject to a trust that arises upon receipt of the money. The client money rules are therefore intended to protect all the clients' money received prior to a PPE. The distribution rules are intended to protect all the clients' money in the event of a PPE, all client money is subject to a statutory trust and where there is a choice of possible interpretations, the court should adopt the one which affords a high degree of protection for all clients: [147]. The language of the relevant provisions of CASS 7 tends to support the claims basis for participation in the CMP (i.e. that no segregation is required). As the linguistic points are not conclusive, it is necessary to stand back from the detail and ask which interpretation better promotes the purpose of CASS 7. This clearly supports the claims basis: [159].

As to whether the primary pooling arrangements apply to client money held in house accounts, it is necessary to decide whether 7.9.6(1)R requires all identifiable client money to be treated as pooled, or only that client money which is held in the firm's segregated client accounts. Since an examination of the text shows that there are two possible interpretations of the relevant CASS 7 rule, the correct interpretation is the one which best promotes the purpose of CASS 7 as a whole, namely to provide a high level of protection for client money. To exclude identifiable client money in house accounts from the distribution regime runs counter to this policy. The alternative would provide different levels of protection based on the happenstance of whether the firm has segregated money, which is arbitrary: [164]-[165]. The primary pooling arrangements apply to client money in house accounts: [167].

References in square brackets are to paragraphs in the judgment

NOTE

This summary is provided to assist in understanding the Court's decision. It does not form part of the reasons for the decision. The full judgment of the Court is the only authoritative document. Judgments are public documents and are available at:

www.supremecourt.gov.uk/decided-cases/index.html