

Alert

LBIE Update — UK Supreme Court Upholds Decision Expanding Client Money Pool Scope and Eligibility

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On Feb. 29, 2012, the Supreme Court (the “Supreme Court”), the UK’s highest court, issued a majority decision upholding the U.K. Court of Appeal’s Aug. 2, 2010 ruling¹ regarding the scope of, and participation in distributions from, the Lehman Brothers Europe (International) (“LBIE”) pool of client money.² The Supreme Court’s landmark decision applies to all customers who agreed with their investment firm counterparty that their money would be treated as client money under the U.K.’s Financial Services Authority’s Rules (the “FSA Rules”), whether or not such money was actually segregated by the investment firm in accordance with the FSA Rules. The decision thus may impact not only holders of client money claims against LBIE, but also similarly situated holders of client money claims against MF Global UK, the London arm of futures merchant MF Global Inc.

The Supreme Court’s decision: (1) expands the pool of client money, which is afforded priority treatment, to now include money that LBIE should have, but failed to, properly segregate as client money; and (2) permits clients whose money had not been actually segregated (“Unsegregated Clients”) to have the same rights to distributions from the client money pool as clients whose money had been segregated properly (“Segregated Clients”). The decision affirms the Court of Appeal’s ruling, which had reversed a High Court decision that held that Unsegregated Customers were not entitled to participate in the customer money pool, but would be subject to other tracing remedies available under U.K. law.

Under the FSA Rules, LBIE was required to segregate client money received from its clients (FSA Rules, CASS 7). The Supreme Court agreed with the High Court that LBIE failed to meet that requirement on a “truly spectacular scale.”³ In addition to requiring segregation of customer funds, CASS 7 creates a statutory trust over client money and, in the event of an investment firm’s failure, such client money is pooled and distributed to clients on a pro-rata basis. The issues before the Supreme Court were: (1) whether the statutory trust arises on receipt of the customer funds or upon the investment firm’s segregation of the funds; (2) whether the pooling requirements apply only to the segregated accounts or also to customer money not segregated from the investment firm’s house accounts; and (3) whether participation in distributions from the pooled client money is only available to Segregated Customers or also available to Unsegregated Customers.

¹ For more information on the Court of Appeal decision, see *SRZ Client Alert* (Aug. 10, 2010) “U.K. Appeals Court Expands Scope of Client Money Pool and Universe of Clients Eligible for Client Money Pool Distributions” available at: http://www.srz.com/081010_LBIE_Update_UK_Appeals_Court_Expands_Scope_of_Client_Money_Pool/.

² *In the Matter of Lehman Bros. Int. (Europe) (In Administration) and In the Matter of the Insolvency Act 1986*, [2012] UKSC 6 (appeal taken from the Court of Appeal Civil Division) (U.K.) available at: http://www.supremecourt.gov.uk/docs/UKSC_2010_0194_Judgment.pdf.

³ *In the matter of Lehman Bros. Int. (Europe) (In Administration) and In the Matter of the Insolvency Act 1986*, [2010] EWCA Civ 917, at ¶ 129 (appeal taken from the Court of Appeal Civil Division) (U.K.).

The Supreme Court dismissed the appeal by majority and held that:

- The statutory trust arises at the time an investment firm, such as LBIE, receives client money and not at the time client money is actually segregated. In deciding this issue, Lord Walker noted that it would be “unnatural and contrary to the primary purpose of client protection” for such money to stop being treated as the client’s property when the investment firm received the funds and then to become treated as the client’s property again upon segregation;⁴
- The pooling requirements apply to all client money, including identifiable client money deposited in house accounts and not properly segregated in client accounts. Lord Walker and Lord Dyson agreed⁵ on this issue and reasoned that the purpose of the CASS 7 scheme was to provide a high level of protection for all clients and client money held in each money account of the firm. That purpose would be frustrated if the pool were arbitrarily limited by the “happenstance” of whether the firm has segregated the money; and⁶
- A client’s participation in distributions from the client money pool is not dependent on whether the client’s money actually had been segregated. The three lords forming the majority applied a purposeful interpretation approach, reasoning that the purpose of CASS 7 is to safeguard the assets of *all* clients.⁷

The decision likely will result in the dilution of the Segregated Clients’ expected distributions from the customer money pool and will lead to increased uncertainty, and potentially litigation, over exactly which (previously unsegregated) funds should be added to the customer money pool and precisely who is entitled to a share of the pool. Lord Walker acknowledged that distribution of client money by the LBIE administrators in accordance with the Supreme Court’s decision would be complex and would take a long time to complete on account of the extraordinary circumstances of LBIE’s case. In other cases, Lord Walker noted, “the position might well be very different” and it would not be right to allow the “scale of the exercise” to lead to a solution contrary to the purpose of CASS 7.⁸

The decision represents a positive development for the estate of the U.S. broker-dealer, Lehman Brothers Inc. (“LBI”), whose liquidation trustee has been urging client money protection for property of LBI customers whether properly segregated or not. It is also a welcomed decision for certain customers of MF Global UK, who claim that their funds should have been, but were not, properly segregated prior to the commencement of that firm’s Special Administration proceedings.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

⁴ See *id.* at ¶ 63.

⁵ See *id.* at ¶ 113.

⁶ See *id.* at ¶ 165.

⁷ See *id.* at ¶ 159.

⁸ See *id.*

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