

Lehman Brothers: return of trust assets

This note considers the prospective Court application by the Joint Administrators of Lehman Brothers International (Europe) Limited ("LBIE") in relation to the return of securities and cash being held by it on trust for its clients.

On 25 February 2009, the Administrators of LBIE submitted an application to the Court in relation to the treatment of Trust Property. "Trust Property" is property of, or held in the name of, or otherwise to the order of, LBIE, which is subject to trust or proprietary claims (together "Trust Claims"), whether comprising monies under the FSA's Client Money Rules ("Client Money") or other monies or assets ("Trust Assets"). This application will be heard in 17 days time and affected LBIE clients are invited to make representations at this hearing.

Rationale for the application

It is clear from the evidence in support of the application that the Administrators have faced, and continue to face, considerable difficulties in determining Trust Assets claims. The application is supported by a detailed witness statement from Steven Pearson, one of the Administrators. One of the key difficulties facing the Administrators is that, to date, it has not been possible to provide any finality to clients in relation to their Trust Asset claims.

There is a material concern that, as only approximately 56% of those clients which the Administrators believe may have Trust Property held by LBIE have responded as part of the current claims process, any return of assets made now to clients may subsequently need to be reversed. This might occur, for example, in the event that there should turn out to be valid competing claims to the relevant assets. In consequence, on the rare occasions that the Administrators have felt able to return assets to a particular client, they have only been willing to do so against a detailed and extensive deed of undertaking from the client (which is usually required to be supported by third party guarantees and/or other security).

The Administrators acknowledge that this current approach is unsatisfactory. It does not provide any finality to clients who may remain liable under their undertakings for many years. Further, the requirement for external credit support has proved hard to meet in certain circumstances – especially where a client is itself experiencing financial difficulties.

Possible Scheme of Arrangement for return of Trust Property

The Administrators, therefore, seek an order from the Court allowing them to propose a scheme of arrangement (a "Scheme"). A Scheme is a compromise or arrangement proposed between a company and its claimants, or any class of them. No final decision has yet been made by the Administrators to proceed with a Scheme. The decision as to whether to do so, and the terms of the Scheme, will be determined and developed by the Administrators after consultation with a working group formed with the creditors' committee, as well as presentations to industry bodies. If it is concluded that a sufficiently well-formulated Scheme can be promoted, a further application would then need to be made to the Court to summon a meeting of the relevant class of creditors. If a majority in number representing 75% in value of the class of creditors present and voting either in person or by proxy agree the arrangement, then the Court may subsequently sanction the arrangement. The effect of such a sanction is that the arrangement would then become binding on all relevant creditors.

Any proposed Scheme will be limited to dealing with claims for the return of Trust Assets and certain other Client Money claims. The Scheme will not deal with general unsecured claims.

The aim of any Scheme would be to establish each claimant's entitlement to Trust Property and ultimately to distribute the Trust Property between those so entitled. Entitlement to Trust Property will be based on each claimant's rights under their contractual documentation with LBIE and the general law. The Administrators will, therefore, be required to assess each claim individually – although one of the objectives of the possible Scheme would be to ensure that it can be promoted and approved expeditiously and avoid needless controversy or issues on which it might prove difficult to obtain consensus.

A key feature of any Scheme is likely to be the imposition of a binding final claims submission date for Trust Claims. Any claim information provided after this date would be disregarded to the extent that it is inconsistent with LBIE's books and records. The rationale for the imposition of a final claims submission date is that it would limit the information that the Administrators will be required to have regard to when determining claims and therefore provides some finality. Once the decision has been made to proceed with a Scheme, the Administrators would make the final claims submission date as public as possible. The Administrators have, however, indicated that they would like the final claims submission date to be as soon as reasonably practicable (as may be acceptable to creditors and the Court).

Any Scheme will need to incorporate mechanics to deal with issues arising in relation to Trust Claims, for example, the risk of competing Trust Claims in circumstances where claimants have agreed that LBIE can off-set any sums due to LBIE or its affiliates against their assets and monies, or where non-affiliates are asserting claims in respect of Trust Property. Any Scheme would also need to be designed to allow court determination of any legal issues arising.

Under any Scheme, claimants with valid Trust Claims are unlikely to recover in full, not least because some or all of the Administrators' costs in dealing with Trust Assets are likely to be borne by the Trust Assets.

Legal issues arising in relation to Trust Assets

Aside from the prospective promotion of a Scheme, the present application is of interest because it highlights a number of legal issues that have faced the Administrators. The resolution of these issues may ultimately affect the value of any particular claim to Trust Property.

One of the biggest practical problems that the Administrators appear to be facing in determining the legal issues is the difficulty in obtaining a complete set of contractual documents from the LBIE systems. In respect of Prime Brokerage clients, the LBIE "standard" agreements were varied over time, and in some cases, were amended on an incremental basis. The position of any prime broker brokerage client can only be established once all agreements are located and reviewed. A further practical problem is that the Administrators have not always been able to determine from the account name(s) on the LBIE systems the name of the relevant client; and have had difficulty obtaining access to relevant information held in systems operated by other Lehman entities, central securities depositories and custodians.

As at 31 January 2009, the Administrators' legal advisers have reviewed contractual documents relating to over 1,000 counterparties. A number of legal issues affecting the Trust Claims have arisen as a result of this review, for example:

- whether the assets held by LBIE are held by them outright by way of transfer of legal title or other appropriation;
- the extent to which LBIE had the right of re-use in relation to securities held by them, and the extent of any restrictions on this right;
- whether LBIE holds security over Trust Assets which may entitle it to withhold the assets;
- whether there are arrangements in place which enable LBIE to withhold those assets until liabilities to its affiliates are satisfied.

Effect of exercise of termination rights

A particular issue which may affect a number of LBIE's prime brokerage clients is the impact of the notices terminating their prime brokerage arrangements on any securities that may be subject to a Trust Claim. This issue only relates to securities where LBIE has not exercised any right of re-use - if an asset has been appropriated by LBIE pursuant to its rights of re-use, it will no longer hold the asset on trust for the client. One of the English law versions of the International Prime Brokerage Agreement – the "IPBA Charge Version" – provides that title to securities held with LBIE remained with the client, but LBIE took a charge over the securities (which was coupled with a right of re-hypothecation).

The close-out provisions of the IPBA Charge Version have caused much interest in the market. On one interpretation, exercise of the close-out right (by reason of LBIE's entry into administration) converts all obligations of the parties into a single net unsecured claim to a monetary payment – either due to or from LBIE. While such an effect would be expected in an absolute title transfer arrangement, this result would be unusual where a collateral-taker (i.e. LBIE) has only a security interest in the collateral. In normal circumstances, a collateral-giver retains a proprietary interest in the collateral and will have a proprietary claim to the return of the collateral upon repayment of the secured obligations. This distinction between a proprietary claim to assets upon discharge of any secured obligations and an unsecured claim to their return is, in normal circumstances where the collateral-taker remains solvent, of limited significance. However, it assumes considerable significance where the collateral-taker, such as LBIE, is or is likely to be insolvent. If, upon termination of the IPBA Charge Version a client has only an unsecured monetary claim for a sum equal to the value by which its collateral exceeds the secured obligations, then the client will only be entitled to a unsecured dividend. If, however, the client retains a proprietary interest in the excess collateral, the excess collateral will not form part of LBIE's property available for distribution to its general creditors on a pari passu basis – the client will be entitled to delivery of all of the excess collateral.

This issue is, therefore, of considerable significance to clients and their likely recovery in relation to their Trust Assets. Resolution of the issue turns upon the proper construction of the intention and effect of the close-out provisions of the IPBA Charge Version. The

The Administrators have stated that they intend to make a separate application to the Court to resolve this issue, although they have not given any indication as to when this application will be made.

Conclusion

A large number of LBIE's clients continue to face significant difficulties and distress as a result of the uncertainty as to if or when their property will be returned to them. Whilst this is acknowledged by the Administrators, it is not possible based on current information to answer these questions definitively. However, this most recent update goes some way to explain how individual categories of Trust Property claims are currently being dealt with and what steps the Administrators intend to pursue in the immediate future to expedite resolution of the considerable legal, operational and practical difficulties that are being faced in finalising entitlements to Trust Property.

The hearing of the Administrators' application will take place on 16 March 2009. The Administrators are inviting any person who is seeking to bring a Trust Claim to make representations at this hearing. If you would like to discuss the possibility of making representations or to discuss any other issues raised in this note, please contact one of our team.

Disclaimer

Please note that the contents of this note provide an overview only. It is intended as guidance only and should not be relied upon as legal advice. Clients' circumstances will differ in each case.

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