

Lehman Brothers: Court rejects proposed scheme of arrangement

Further to the Application by the Administrators of Lehman Brothers International (Europe) ("LBIE") on 14 July 2009, the High Court in London has rejected the scheme of arrangement proposed by the Administrators which was intended to facilitate the return of client assets held by or on behalf of LBIE (the "Proposed Scheme"). This note considers the background to the Proposed Scheme, the court's decision and the implications for our clients.

Background to the Proposed Scheme

LBIE acted as prime broker and/or custodian for institutional clients. As a result of the contractual agreements it had with those clients, for example, under certain versions of the International Prime Brokerage Agreement, the Master Custody Agreement and the Margin Lending Agreement, many LBIE clients have proprietary interests in assets held by or on behalf of LBIE. Where a client has such a trust claim in relation to an asset, the client is, at least in theory, entitled to the return of this asset.

In practice, the Administrators are facing a huge range of complex issues in seeking to give effect to LBIE clients' entitlement to the return of their assets. Such clients often owed amounts to, or were owed amounts by, LBIE or its affiliates. The exercise of working out the net positions between LBIE and its clients, both in the context of the administration and in light of the fact that LBIE might have recourse to trust property for amounts owed to it, is extremely complex. It is further complicated by a lack of certainty as to the identity of all possible claimants and competing claims in relation to the same asset.

As a result of these issues, the Administrators proposed a Scheme under Part 26 of the Companies Act 2006. The rationale for the Proposed Scheme was to provide certainty and finality as to the pool of claimants to whom trust property may be distributed once claims had been properly made and assessed.

In summary, the Proposed Scheme was intended to apply to clients of LBIE who had a pecuniary claim against LBIE and who owned assets held or controlled by LBIE (each a "Scheme Creditor"). As drafted, the Scheme was intended to deal with all of the Scheme Creditors' claims for the return of their trust property. In broad terms, trust property included securities held by LBIE at the time of the administration on a segregated basis, assets derived from those securities including cash, and securities that had been delivered by LBIE to third parties after the administration but subsequently redelivered to LBIE.

The key feature of the Proposed Scheme was that a Scheme Creditor would agree to release its proprietary claim against LBIE and other creditors. In return, it would have its asset claim satisfied on a pooled basis, ranking alongside and in competition with others who were able to establish a claim in respect of the same asset (to the extent that the securities comprising that asset were available to meet those claims). In relation to any unsatisfied asset claims and any claims relating to its net position on financial contracts with LBIE, they would retain unsecured claims against LBIE.

The court's decision on Friday 21 August 2009

Mr Justice Blackburne held that the Court did not have jurisdiction to sanction the Proposed Scheme insofar as it was concerned with distribution of trust property and where it sought to do so in ways that would vary, or in some cases, extinguish, those property rights. A scheme of arrangement could only compromise the rights of "creditors" – proprietary rights were not the rights of a creditor. The property in question had never been the property of LBIE; it had been entrusted to LBIE by its clients. The obligation of LBIE was therefore to administer the trust in accordance with its terms and to return the property to its clients if that is what its clients requested. If the Proposed Scheme were to be sanctioned, it would mean that its participants could vote to over-ride the proprietary claims (assuming that the requisite majority could be achieved). This would violate the fundamental rights of property ownership enshrined in English law.

In reaching this decision, the judge expressed sympathy with the task faced by the Administrators: *"[G]iven the exceptional problems that the administrators face in dealing with client assets and the very great effort that they have devoted to devising a means, by way of a scheme under Part 26, to bring about a speedy return of those assets, this is not a conclusion which I am happy to reach. But I must set out the law as I see it, not as I might wish it to be."*

Leave to appeal this decision has been granted and the Administrators have indicated that they intend to appeal. It is hoped that any appeal hearing will be dealt with on an expedited basis in November 2009. In the event that an appeal is successful, the Administrators will then be required to convene a meeting of Scheme Creditors where they can vote on the Proposed Scheme, and a further hearing will be required in order for the court to sanction it. On this basis, the Administrators believe that the earliest any scheme is likely to become effective is in the first quarter of 2010.

Implications

Whilst this decision will have a direct impact on clients whose assets are held by LBIE, it should also be noted that any decision in relation to the entitlement and distribution of trust assets will impact on the likely distribution to unsecured creditors and others with purely personal claims.

Interestingly, Mr Justice Blackburne stated that, whilst he did not underestimate the difficulties that the Administrators face in the event that they are unable to promote the Proposed Scheme, he questioned whether these difficulties were insuperable. He noted that, in the absence of a scheme of arrangement, the court has well-developed processes to deal with complex trust law issues and therefore would be able to assist the Administrators and LBIE in relation to issues arising, whilst ensuring that they are protected from liability. Although the Administrators have made it clear that they have not given up on the idea of a scheme of arrangement at this stage, they have indicated their willingness to consider alternative approaches. Any such approaches are likely to require the assistance of the court as envisaged by Mr Justice Blackburne.

The Administrators have also indicated that they intend to consider whether the Proposed Scheme can be revised to eliminate the jurisdictional problem and still be used to facilitate the return of assets. This possibility has not been ruled out by the court. Indeed, Mr Justice Blackburne stated that a scheme of arrangement could be used in order to effect some of the Administrators' objectives, such as imposing a bar date for claims and establishing a mechanism for valuing claims. However, unless this recent decision is successfully appealed, the terms of any amended scheme are likely to differ significantly from the Proposed Scheme as currently drafted.

Finally, clients should bear in mind that the Proposed Scheme was simply designed to be a framework into which various methodologies were to be packaged to speed up the process for the release of trust assets. The Administrators will continue to work on these various methodologies whether or not a Scheme is sanctioned and will continue to return assets to clients through bilateral negotiations. As a result, clients who believe that they have a proprietary claim against LBIE should not wait for the outcome of any further appeal on this matter and should take all steps to prove their claim as part of LBIE's ongoing adjudication process.

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28 August 2009

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