



Lehman: proposed scheme of arrangement

COURT OF APPEAL JUDGMENT HANDED DOWN ON 6 NOVEMBER 2009

The Court of Appeal handed down its decision on 6 November 2009 upholding the High Court decision that a scheme of arrangement is not an appropriate mechanism by which the administrators of Lehman Brothers International (Europe) (LBIE) can return assets to LBIE's clients. This briefing outlines the background to the decision and the reasons for it.

Background to the decision

As is well known, Lehman Brothers International (Europe) (LBIE) holds very substantial assets as trustee on behalf of prime brokerage, custody and other clients. Although the administrators must return the assets to the relevant clients, identifying the assets referable to each client so that they can properly be returned has posed very significant practical difficulties. The administrators recognise the need to find a swifter, simpler way of returning trust assets to the LBIE clients to whom they belong and who have been kept out of those assets since September 2008. They have been trying to find a means of resolving this.

In March 2009, the administrators obtained the High Court's permission to explore the use of a scheme of arrangement under part 26 of the Companies Act 2006 to facilitate the return of the trust assets. When granting permission, the Court noted that there was an issue over whether it had the jurisdiction to sanction such a scheme of arrangement and the administrators agreed to return to the Court for a hearing on that question once the scheme had been sufficiently developed.

The first instance hearing raised a short, but important, point of principle. The proposed use of a scheme of arrangement was novel, in the sense that the scheme would compromise the proprietary rights of the beneficial owners of the trust property. A scheme would normally compromise rights of *creditors*. Beneficial owners of trust property are not generally treated as creditors of the trustee.

The point may seem esoteric, but it goes to the heart of the protection that the law gives to trusts. Essentially, trust structures work because an owner's proprietary rights to their assets are inviolable (subject to well-known exceptions). Importantly, those rights are not affected by any insolvency of the trustee.

Trust structures are, of course, commonly used within the financial services industry – for example, for custody relationships and in securitisations and many other forms of financing. If it were possible for a corporate trustee to subject trust assets to a scheme, then that would allow the majority of beneficial owners of property held by that trustee to impose on the minority a compromise of their rights to their own trust property. Since a scheme of arrangement can be proposed by a solvent company, as much as an insolvent one, any party with assets held by a corporate trustee would be subject to risks that are presently not fully understood.

Whatever the answer, therefore, this was an important, and potentially far-reaching, point that needed properly to be considered by the Court. In August, Mr Justice Blackburne decided that there was no jurisdiction to sanction a scheme of arrangement insofar as it would vary or extinguish proprietary rights to assets held on trust by LBIE. The administrators appealed and, at a hearing on 26 October, the same point of principle was examined by the Court of Appeal.

The reasons for the appeal decision

In a unanimous decision, the three Court of Appeal judges (the Master of the Rolls (Lord Neuberger), Lord Justice Longmore and Lord Justice Patten) dismissed the appeal and upheld the decision of Mr Justice Blackburne in the lower Court.

The position therefore is that there is no jurisdiction to sanction the proposed LBIE scheme of arrangement, insofar as it is concerned with the distribution of trust property (ie assets held on trust by LBIE for its clients) and seeks to do so in ways that will vary or in some cases extinguish clients' proprietary rights.

The Court of Appeal's decision, however, cast no doubt on the use of schemes of arrangement to compromise secured creditors' rights, which is a common feature of recent restructuring schemes.

The Court of Appeal expressed some sympathy with the administrators' efforts to return trust property. Lord Justice Patten, who gave the leading judgment, described the scheme proposal as 'a considered attempt to overcome the difficulties faced by the administrators'. However, the judges did not accept their legal position.

The London Investment Banking Association (LIBA) appeared in the appeal (as at first instance). It indicated that it supported appropriate efforts made by the administrators expeditiously to return LBIE client assets, but that it was concerned that the use of a scheme of arrangement in this way could undermine the fundamental inviolability of trusts – thereby (among other things) lessening the legal protection given to UK-custodied assets.

The Court of Appeal's judgment strongly re-affirms the separate and distinct status of a customer's proprietary rights to their own assets held for them by a company as trustee. Lord Justice Patten commented that '... the trust mechanism has long been regarded as an important safeguard against insolvency and has been imported into commercial contracts for that very reason. In the case of pure custody agreements, it is of course paramount.'

Section 895 of the Companies Act 2006 permits a scheme of arrangement, which is an 'arrangement' between 'a company and its creditors'. The Court of Appeal held that a beneficial owner of property held on trust is not a creditor of the trustee for this purpose. A 'creditor'

consists of anyone who has a monetary claim against the company that, when payable, will constitute a debt. Moreover, an 'arrangement between a company and its creditors' means an arrangement that deals with their rights inter se as debtor and creditor. It excludes the rights of creditors to their own property, which is held by the company for their benefit.

The Court rejected the administrators' submission that the reference to a 'creditor' was no more than a gateway, so that if a person was a 'creditor' of the company for any purpose a scheme could be sanctioned that would compromise or remove rights that the creditor does not hold as a creditor.

'That would, I think, be inconsistent with the express purpose of the legislation which must be to allow the company to re-arrange its contractual or similar liabilities with those who qualify as its creditors. A person is the creditor of a company only in respect of debts or similar liabilities due to him from the company. I am not persuaded that Parliament can have intended to allow creditors to be compelled (if necessary) to give up not merely contractual rights but also their entitlement to their own property held by the company on their behalf.' (Lord Justice Patten)

The Court also rejected the administrators' argument that there was little legal distinction between a trust beneficiary and a creditor in the context of an agreement such as an international prime brokerage agreement, which was an 'overall commercial arrangement':

'The commercial nature of these agreements is not in dispute but the trust mechanism has long been regarded as an important safeguard against insolvency and has been imported into commercial contracts for that very reason. In the case of pure custody agreements, it is of course paramount. I do not therefore accept that the trust element in these arrangements ought in some way to be merged into the general contractual framework and treated merely as ancillary when considering the limits of the Scheme jurisdiction...' (Lord Justice Patten)

Lord Neuberger gave a short judgment, in which he agreed with Lord Justice Patten. He too rejected the administrators' argument that a scheme can be approved provided the beneficial owner of trust assets is also a creditor (who has a monetary claim against a company).

‘The practical consequences of [this] would also be startling. Why should the mere fact that a beneficiary happens also to be a creditor of the company entitle the company, or its liquidators or administrators, to include his property in a scheme, when they could not otherwise do so? What commercial sense or logic is there in the notion, which would follow from this contention, that a beneficiary who is also a creditor could take the trust property out of the potential grasp of a scheme by waiving the debt, or by assigning the debt to another person? Equally, what commercial sense or logic is there in the notion that the company could engineer trust property being potentially brought within a scheme by breaching the trust, thereby creating a claim, and thus a debt, in favour of the beneficiary?’

Lord Neuberger concluded as follows:

‘Like Patten LJ and Blackburne J, I have some sympathy with the administrators’ desire to have a scheme under section 895 which extends to trust property, in the light of the difficulties which would otherwise almost certainly arise in connection with seeking to satisfy the rights of beneficiaries in relation to trust property held in the name of LBIE. However, as Blackburne J held, the fact that such a Scheme might well represent a reasonable proposal in this case is plainly not enough to bring the scheme within the ambit of section 895, and, as is evidenced by the opposition to the proposed Scheme mounted by LIBA, it may, viewed in the wider perspective, be positively undesirable that such a Scheme could be approved under section 895. I hope, indeed I would expect, that, if the administrators decide to make an application under the Trustee Acts or pursuant to the Court’s inherent equitable jurisdiction, in relation to dealing with beneficiaries’ rights, the court will provide effective assistance, by arriving at a practical and fair outcome, while ensuring that delay and cost are kept to a minimum.’

The administrators will now need to progress alternative means of facilitating the return of assets to LBIE’s clients. Since the first instance judgment, the administrators have been promoting an alternative (contractually based) solution. It will be interesting to see how this alternative solution develops.

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