News Bulletin

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Collateral Trapped is Collateral Damage in the Wake of the Lehman Brothers Debacle

On 24 November 2008, the High Court dismissed an application made by four US investment funds in the matter of Lehman Brothers International (Europe) ("**LBIE**") and PricewaterhouseCoopers ("**PWC**"), the administrators of the now defunct European arm of Lehman Brothers banking group (the "**Lehman Group**").[1]

The judgment rendered by The Honorable Justice Blackburne underscores the non-interventionist stance being adopted by English courts with regard to applications made by former clients of the prime brokerage business of LBIE, whether the applicants are seeking the return of securities held by LBIE on their behalf (as was the relief sought, but denied by the court, in the recent case of RAB Capital plc[2]) or simply more information concerning their securities (as in this particular case). The judgment stated that the courts, whilst sympathetic to the financial misfortunes of LBIE's former prime brokerage clients, would refuse to interfere with the administrators' conduct of the administration, except for good cause. The administrators were to be accorded wide latitude in deciding, from day to day, how to go about achieving the statutory purpose of the administration, which is to obtain a better result, compared to a winding-up, for the company's creditors *as a whole*. Absent improper or wrongful conduct on the part of the administrators, the courts will leave it up to the administrators to decide on the *modus operandi* for the day-to-day conduct of the administration process.

Background to the Contractual Relationship

Each of the four applicant funds was a party to a prime brokerage agreement with Lehman Brothers Inc. ("**LBI**"), a US-incorporated entity and LBIE, a UK-incorporated entity, and a margin lending agreement with LBIE which was arranged by LBI acting as agent. LBI maintained the prime brokerage account under the prime brokerage agreement and LBIE maintained the lender's account under the margin lending agreement. As part of these New York law-governed arrangements, the funds lodged securities with LBI, acting as their prime broker, as security for the payment of their liabilities to any Lehman Group entity. LBI in turn transferred those securities to LBIE, which was authorised to provide loans and other services to the funds, secured by those securities. The margin lending agreement also authorised LBIE to lend the securities and to pledge, re-pledge, hypothecate or re-hypothecate them, provided that (unless otherwise agreed) the funds would continue to be entitled to any distributions made in respect of the deposited securities.

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[1] In the matter of *Lehman Brothers International (Europe) (In Administration)* and the Insolvency Act 1986: Four Private Investment Funds vs. Joint Administrators, [2008] EWHC 2869 (Ch.), dated 24 November 2008, available at http://www.bailii.org/ew/cases/EWHC/Ch/2008/2869.html.

[2] *RAB Capital plc and RAB Capital Market (Master) Fund vs. Lehman Brothers International (Europe)*, [2008] EWHC 2335 (Ch.), dated 22 September 2008, available at http://www.bailii.org/ew/cases/EWHC/Ch/2008/2335.html .

The Settlement Date That Never Happened

According to the applicants, around 12 September 2008, when it became clear that the Lehman Group was facing severe financial difficulties, the applicants started to make arrangements with LBI for most of their securities to be transferred to a third party bank, against payment by the third party bank of all outstanding liabilities of the funds to the Lehman Group. According to the applicants, this transfer was due to settle on 16 September 2008, the day after Lehman had collapsed, but was blocked by the intervening insolvency.

The Legal Battle That Ensued

Following the non-settlement, the applicant funds sought various information from the administrator of LBIE, but claimed unjustified failure to provide all of the requested information, such as an indication of the time scale for the administrators identifying, and returning, "client assets". The applicants asked the court to make an order, either pursuant to the court's equitable jurisdiction in respect of trusts or under paragraph 68(2) or 74(1)(b) of Schedule B1 to the Insolvency Act 1986, directing the administrators to supply the relevant information.

The applicant funds contended that there was no legal impediment to their securities being returned to them on the intended settlement date, and that outstanding loans and other obligations to LBIE would have been discharged by the third party bank immediately upon transfer of the securities on that date. Putting forward documentary and recorded evidence in support, they sought to demonstrate in particular that any previously re-hypothecated securities had already been released or would have been released from hypothecation, and thus available for transfer on the settlement date.

The applicants stated that the purpose of their application was not to obtain the immediate transfer of the securities (which was likely to be denied in light of the RAB Capital judgement) but to obtain "further and better information about the state of their securities" than the administrators had so far provided in response to their earlier requests. They maintained that the administrators showed a "marked reluctance" to assist with the information which should have been available to them already or easily obtainable by them, and that the "excuses" they gave for not doing so were unsatisfactory. The applicants further argued that the information they sought to elicit from the administrators was vital to their ability to subsist as funds and to retain the confidence of their investors beyond mid-December 2008. Lacking such information, they continued it was "likely that the funds [would] be wound down forthwith" and consequently, the funds' property at LBIE would have to be treated as irrecoverable, leading in all likelihood to the "collapse of at least four companies in which securities are held", owing to the inability of the funds to vote on restructuring proposals.

The administrators countered the applicants' case by adducing extensive evidence of the intricate nature of LBIE's prime brokerage business and refuting the funds' contention that the securities were available for transfer on the settlement date. The administrators argued that LBIE had a right to re-use the securities as collateral for other transactions, that account discrepancies complicated the process of identifying the relevant securities, and that there may be competing third party claims, as US securities were generally held in a single omnibus account at the Depositary Trust Company in the US, whereas client securities which were not so re-used were held in pooled client custody accounts with third party custodians. More crushingly, the administrators explained that there were approximately 140,000 failed or pending trades and unrecorded corporate events in LBIE's books and records which needed to be "reviewed, reconciled with external data and then either settled, unwound, cancelled or otherwise addressed in order to bring LBIE's trade database systems up to date". The reconciliation of trades would have to be completed before the administrators could determine the final positions, including which former LBIE clients have a claim over those securities, whether there are competing claims in respect of the same securities and how best to resolve the conflicting proprietary interests. Until these processes were completed, they were unable to say with any certainty whether securities could be returned in full to any given client or whether a shortfall existed which must be shared *pro rata* across all client holdings.

Furthermore, the administrators contended that "they should not be required to devote a disproportionate amount of time to one particular counterparty which is seeking to have its case put to the top of the queue by commencing legal proceedings and by exerting pressure on the administrators in this way." They contended that they would not be able to properly discharge their statutory functions if they were to divert resources to conduct the type of investigations which would be necessary in order to obtain the information requested by the applicants or by other clients of LBIE in a similar predicament.

Administrators Not "At the Beck and Call of Each and Every Creditor" – Court Will Not Intervene in the Absence of Improper or Wrongful Conduct on the Part of Administrators

Mr. Justice Blackburne concluded that the court did not have the jurisdiction to make the order applied for and dismissed the application by the funds.

Under paragraph 74(1)(b) of Schedule B1 of the Insolvency Act 1986, an administrator's conduct of the administration may be challenged if it "proposes to act in a way which would unfairly harm the interests of the applicant". On the facts of this case, however, the administrators' refusal to supply the information did not "unfairly harm" the interests of the applicant funds within the meaning of paragraph 74(1)(b). In particular, Mr Justice Blackburne found it significant that there was "no suggestion that the administrators [were] acting other than in accordance with their obligations". Accordingly, the court found it "exceedingly difficult to see how the unwillingness of the administrators to devote more time and resources than they have already to answering questions put to them by a particular group of creditors … about assets which the creditors claim are theirs can be said to be unfair even if it can be said to be causative or likely to be causative of harm."

Under paragraph 68(2) of Schedule B1 of the Insolvency Act of 1986, the court is empowered to give binding "directions to the administrator … in connection with any aspect of his management of the company's affairs, business or property."

The administrators' proposals for dealing with LBIE's client assets were approved at a creditors' meeting on 14 November 2008. The court asserted that "the administrator must be accorded a wide measure of latitude in the way he goes about the exercise of his powers so as to achieve his statutory purpose. His task would become quite unmanageable, particularly in an administration as immense and complex as LBIE's, if he is to be at the beck and call of each and every creditor wishing to be informed about his claim or asset and who expects the administrator to turn aside from the general conduct of the administration and devote time and resources to responding to his enquiries."

Therefore, "[w]here, as here, there is no suggestion that the administrator is acting improperly, it would run flat contrary to the nature and purpose of an administration if the court were to interfere in the detailed day to day management of the administration in the way that this application seeks ... in the absence of some plainly wrongful conduct on the administrator's part, it is for him to decide where the balance lies".

Accordingly, the court declined to exercise its discretion under paragraph 68(2) and its wider equitable jurisdiction in respect of trusts and trustees to entertain the funds' application.

Options Available to Clients Seeking the Release of Trapped Assets

It seems quite clear that the circumstances in which an English court will interfere with the management of the administration are very restricted. This, however, does not rule out the possibility of claimant's negotiating a settlement with the administrators for the release of assets in return, for example, for the provision of satisfactory indemnity. However, if the relationship between the claimant and the company in administration is complex or there are competing claims, or further investigations are required by the administrators to establish the exact proprietary interests of third parties, the administrator is less likely to agree to such a settlement.

Contacts

Peter Green
+44 20 7920 4013
pgreen@mofo.com

Jeremy Jennings-Mares
+44 20 7920 4072
jjenningsmares@mofo.com

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