

## BRIEFING

# Lehman: proposed scheme of arrangement

HIGH COURT JUDGMENT HANDED DOWN ON 21 AUGUST 2009

SUMMARY      AUGUST 2009

**The High Court in London has decided that a scheme of arrangement under the UK Companies Act 2006 cannot be used by the administrators of Lehman Brothers International (Europe) (LBIE) to facilitate the return of client assets to LBIE clients. This briefing outlines the background to the decision, the reasons for it and its implications.**

The High Court in London has decided that a scheme of arrangement under the UK Companies Act 2006 cannot be used by the administrators of Lehman Brothers International (Europe) (LBIE) to facilitate the return of client assets to LBIE clients. In this briefing, we outline briefly the background to the decision, the reasons for it and its implications.

## Background to the decision

As is well known, 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 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 as to whether the Court 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.

That hearing took place on 29 and 30 July. It raised a short, but important, point of principle. The proposed use of a scheme of arrangement was novel, in the sense that it would compromise the proprietary rights of the beneficial owners of the trust property. A scheme would normally compromise the 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 a beneficial owner's proprietary rights to their assets are inviolable (subject to well-known exceptions). In particular, those rights are not affected by the (in)solvency 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 permit the requisite 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. A scheme of arrangement can be proposed by a solvent company, as much as an insolvent one. So, any

party that has entrusted assets to a corporate trustee would find that their rights to those assets are subject to unforeseen risks.

Whatever the answer, therefore, this was an important, and potentially far-reaching, point that needed properly to be considered by the Court.

### **The reasons for the decision**

Mr Justice Blackburne held that the Court does not have jurisdiction to enable the administrators to proceed with a scheme of arrangement insofar as the scheme is concerned with the distribution by LBIE of trust property and seeks to do so in ways that will vary or, in some cases, extinguish clients' proprietary rights.

He acknowledged the difficult circumstances for the administrators of the LBIE administration and the difficulties that they face if they are unable to promote the scheme. However, the Court considered that the effect of the scheme put forward by the administrators would be to interfere with (by varying and, in some cases, extinguishing altogether) the proprietary rights of owners of assets held on trust by LBIE. This interference with property rights could happen against the will of the owner because the variation of rights is approved by the majority vote of the 'creditors' under the scheme. For these reasons, the scheme would violate the fundamental ownership rights of a property owner – to exclude others from enjoyment of the owner's asset or to have that trust property administered according to the terms of the trust.

The Court held that these property rights are not the rights of a 'creditor' and they cannot be interfered with without the owner's consent or in accordance with the terms of the relevant trust. The rights of someone who has placed their assets with a trustee are different from those of a creditor, in that property held on trust for a client remains the owner's property throughout.

Part 26 of the Companies Act 2006 does not apply to property that:

'is not, and has never formed, part of the company's assets and which the company holds as custodian or trustee (either directly or through others) for the clients as beneficial owners. In such a case, which is the position of clients who have entrusted property to LBIE, the obligation of LBIE is to administer the trust according to its terms, and to return the property to the client as beneficiary if that is what the client requests. Part 26 is simply not in point as a means of giving effect to the property rights of the client in question. If LBIE has any interest in the property at all, it is that of a creditor holding security (which may be no more than a lien) for indebtedness owed to the company (or to its affiliates) by the client as its beneficial owner.'

The insolvency of the trustee does not alter this fundamental right of a beneficial owner to his property.

### **Implications and next steps**

The administrators were given permission to appeal the decision and will need to decide whether to do so.

Interestingly, the judge did not think that a scheme was the only available solution and he questioned whether the obstacles, although significant, were insuperable. He endorsed the suggestion that, where there is no jurisdiction for a scheme under company law, trusts law provides mechanisms for enabling trust property to be distributed to its beneficial owners while protecting the trustee from liability.

In particular, he suggested that most of the preliminary work – such as (i) establishing the contractual terms governing the client’s relationship with LBIE, (ii) working out the net contractual position between the client and LBIE and (iii) determining what security (or similar rights) LBIE has over the client’s assets in respect of any balance amounts due from clients to LBIE – would in any case have needed to be undertaken under a scheme of arrangement before any distribution could have been made. These are also matters that could properly be the subject of a scheme.

That leaves the trust law issues. The judge noted that trust law has ‘well-developed processes’ to assist in undertaking those tasks not within the jurisdiction of a scheme – for example, ascertaining how LBIE and the administrators distribute trust property even when there can be no certainty that all of the claimants to it have been identified. The trustee can also seek the protection of a court order in the event that a claimant should subsequently appear or matters come to light that question the basis on which the distribution is made.

He ended his judgment by noting:

‘At the risk of appearing glib, I do not consider that a structured approach of this broad kind is beyond practical achievement in the exceptionally difficult circumstances of LBIE’s administration.’

It will be interesting to see whether the administrators take up the judge’s suggestions on alternative routes forward.

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