Has English law coped with the Lehman collapse?

The Lehman collapse imposed unprecedented strains on English common law and regulatory systems. This article examines the extent to which they passed the test imposed by the biggest international insolvency in history.

The insolvent collapse of the Lehman Brothers group in September 2008 was a cataclysm not merely for the international banking industry. It imposed unprecedented strains on the legal and regulatory systems of all the countries where its main business was based. In England it revealed that investment bankers had stretched time-honoured concepts of the split between legal and beneficial ownership of intangible property to virtual breaking point, and subjected modern regulatory structures to tests way beyond those for which they were designed.

The recent announcement of a provisional settlement between the London based European hub company Lehman Brothers International Europe (LBIE) and the main American hub company Lehman Brothers International Inc (LBI) probably means that the tide of English litigation which has flowed from the collapse is now very much on the ebb, at least at first instance, although there remain some big cases still pending at the appellate level. It is perhaps now possible to begin to address the question whether, and if so how well, English law has coped with the collapse. In particular, have the uncertainties in the legal meaning and effect of widely used contractual and regulatory structures been resolved sufficiently quickly to meet the needs of that large part of the international business community that chooses English law, and the English courts, to govern their dealings?

This article concentrates on three main topics:
- the challenges posed to the common law (ie non statutory rather than non-equity) by the uses to which it has been put by the transaction designers;
- the stresses to which statutory and regulatory schemes have been subjected by the happening of an event for which they were designed, (ie insolvency), but on an unimaginably larger scale;
- the absence of a case management structure which ensures that issues of great ongoing importance to business are dealt with at all levels, including appeal, swiftly.

THE COMMON LAW

Apart from money, the main stock in trade of the Lehman group was dematerialised securities. They are a form of intangible asset represented by an entry in the account of the legal owner of the security, recognising the beneficial owner (or some intermediary between the legal and ultimate beneficial owner) as entitled to a stated number or fraction of an otherwise undifferentiated block of those securities held by the legal owner. There may commonly be a long chain of intermediaries between the legal and ultimate beneficial owner of a particular number of (say) ordinary shares in BP. In English law this tiered structure works, and only works for the purpose of creating proprietary interests at all levels, by the recognition of a trustee/beneficiary relationship between each member of the structure. Otherwise the separation of legal and beneficial ownership, and the creation of intermediate layers of proprietary holders, just does not work conceptually.

Lehman group companies featured in these chains, often being the first level beneficiary (or account holder) beneath the depositary holding legal title to the securities, often holding its interest as custodian for its customers on the street ("clients"), and often for one of its affiliates within the group, either for the affiliate’s house account as ultimate beneficial owner, or for the affiliate as custodian (ie trustee) for one or more of its own clients.

But the group was not content just to hold property of this kind in safekeeping, either for street clients or affiliates, in the way that a traditional trustee might be expected to do under English law (leaving on one side duties to invest and to transpose investments). It wanted to put it to work in the meantime, for itself rather than for its clients, for example by what is known as "lending it to the street". So it bargained with its street clients, and arranged with its affiliates, for what are called rights of use and rights of substitution, in relation to property thus held. So far did these rights or (between affiliates) practices go that in one case they came near to destroying, and in another case actually did destroy, the very substratum or essential features of a trustee beneficiary relationship, so that the client (or affiliate) risked losing (or actually did lose) any proprietary interest in the security, in exchange for purely personal contractual rights as against the Lehman entity holding the security.

For as long as the Lehman group remained a going concern, good for its personal undertakings, this mattered little. The substitution of personal for proprietary rights as against the mighty Lehman entities secured for clients and affiliates the enjoyment of the economic fruits of beneficial ownership just as well. The exercise by the group of rights of use and of substitution no doubt usually swelled its profits in good times, and may even have led to a reduction in fees charged to clients. But the onset of insolvency within the group made the difference between a personal and proprietary right of the utmost importance, not only to street customers, but also as...
by and large, that common law did prove fit for the unplanned purpose. Whether a relationship between two persons in connection with particular property is that of trustee and beneficiary is ultimately a question of intention. This is as true of the relationship between bankers and their customers in connection with securities as it is between cohabitees in connection with a shared home. The point may be illustrated by reference to three cases. In the first case Lomas v RAB Market Cycles (Master Fund) Limited [2009] EWHC 2545 (Ch) the standard form of Lehman International Prime Broker Agreement (Charge version) gave LBIE rights of substitution and use in relation to client property which the agreement otherwise described as being beneficially owned by the client, while held by LBIE. A representative of LBIE’s unsecured creditors argued with force that these rights were irreconcilable with LBIE being the client’s trustee in relation to the property, so that it all fell into LBIE’s insolvent estate, leaving the clients only with claims for its value as unsecured creditors. The court concluded that, taken as a whole, the agreement did disclose a sufficient intention to make LBIE the client’s trustee of the property or its substitute, notwithstanding the conferment of rights on LBIE in relation to it which would have made a 19th century trust lawyer turn in his grave.

In the second case, Pearson v Lehman brothers Finance SA [2010] EWHC 2914 (Ch), [2011] EWCA Civ 1544, generally known by the acronym RASCALS, the Lehman group set up a system for the acquisition and holding by hub companies (ie LBIE in Europe) of all securities which any Lehman company wished to acquire in the relevant territory, so that the hub company held all the securities, between acquisition and sale, for the account of its Lehman affiliates. But the practice within the group was for the hub company to use the securities for its own purposes, including lending to the street for liquidity management, selling to meet short positions of its own or of other affiliates, and generally acting in a comprehensively un-trusteelike manner in relation to the holding, while crediting the relevant affiliate (for whom the security was held) with both its value and with any intermediate income, such as dividends on shares.

Regulatory and capital adequacy concerns in the mid 1990s led to the erection of a complex computer automated structure whereby the relevant securities were made the subject of daily repos or open ended stock loans between the hub company and the relevant affiliate (for the account of which they had been purchased) for the whole of the period between acquisition from and disposal to the street. It operated on a daily basis without any human intervention at all. This structure only made sense on the assumption that the parties intended the beneficial interest to start with the affiliate, ie that they were acquired by LBIE for the affiliate as its trustee. The purpose of the repos and stock loans was then to transfer beneficial ownership of the security in question back to the hub company for the whole period of its holding within the group.

When the music stopped in September 2008, the computer automated process bizarrely continued on its sweet way, doing thousands more repos every day for a further ten days until someone from the administrators asked what the flashing light on the relevant computer was about, found out, and then ordered it to be switched off. The question then arose: who then beneficially owned the underlying securities, LBIE or its relevant affiliates? In the end the answer turned on the intricate mechanics of the automated scheme, coupled with the group’s centralised book entries. But LBIE’s administrators alleged that there could never have been a trust between LBIE and the affiliates in the first place, so that the automated structure was both misconceived and completely unnecessary.

Prior to the erection of the automated structure, that submission would have succeeded. The use which the affiliates allowed LBIE to make of the securities was inconsistent with LBIE being intended to be a trustee. All the affiliate got was a personal right against the hub company to the economic fruits of the underlying securities, which belonged from purchase until re-sale to the hub company, legally and beneficially.

But since the automated structure only made sense on the assumption that the parties assumed they had transferred the beneficial interest to the affiliate, this disclosed, for the first time, a sufficient intention to create a trust so as actually to achieve that result.

More recently, in Re Lehman Brothers International Europe [2012] EWHC 2997 (Ch), known as the Extended Liens case, an unsuccessful attempt was made to imply a trust between LBIE and relevant affiliates as the result of the creation of a charge (misdescribed as a lien) by clients (including affiliates) over property deposited with LBIE as custodian under a standard form Master Custody Agreement, as security for debts owed by the clients not only to LBIE but also to other affiliates. But the requisite necessity for the recognition of a trust by way of an implied term was lacking, and the whole benefit of the charge was an asset in LBIE’s insolvent estate.

These cases demonstrate the continuing vigour and above all flexibility of the common law of trusts in the face of unprecedented challenges, in a very unfamiliar international business environment. The outcome produced both justice and the practical vindication of the parties’ apparent intentions, as discernable from the relevant documents and their habitual behaviour towards each other. By contrast in the USA there has been devised a new artificial legal structure as the conceptual basis for the holding
of dematerialised securities which does not depend upon traditional concepts of the separation of legal and beneficial interests by a trust, as part of their Uniform Commercial Code (UCC). It remains to be seen which will work best for all concerned. For the moment this part of our common law may be rated as having passed a difficult test with distinction.

**STATUTE AND REGULATION**

The same cannot however be said of attempts at statutory intervention, either of a home grown or Euro directive inspired origin.

Two examples will suffice. The first is the Euro inspired set of client money rules known as CASS7, formulated to implement the MiFID directive. The simple objective of these rules was to require financial intermediaries to segregate client money from their own house funds so that, if the intermediary became insolvent, the client money would be safely there, available for swift distribution to those entitled to it, ahead of and immune from the claims of unsecured creditors, and pooled for distribution pro rata in the unlikely event of a shortfall. The basis for the implementation of this laudable objective in the UK was the erection of a statutory trust, baring on all client money after receipt by the intermediary, with detailed provisions about how it should be segregated, accounted for, and distributed in the event of insolvency.

It took no time at all for the Lehman collapse to reveal the utter failure of this statutory scheme to achieve its stated objectives. First, LBIE had completely failed to treat as client money (and therefore to segregate) any money of by far the largest group of its clients, namely its own affiliates. Secondly, it had banked a large proportion of the client money which it did segregate with a particular affiliate, Bankhaus AG, which went as spectacularly bust as the rest of the group. Thus, regardless of the difficulties in understanding how the statutory trust was meant to work, there was always going to be a gaping hole in the trust fund from which the clients were meant to be repaid. This was due to a pair of basic shortcomings in LBIE’s application of the client money rules which apparently wholly escaped the attention of its lawyers, accountants, auditors and regulators.

That might be regarded as bad enough, but at least the clients might nonetheless have received a pro rata share of the sadly reduced client money pool reasonably soon after the collapse, were it not for the crippling uncertainties in the meaning of the client money rules, which it took nearly three years for the courts to resolve, and then only by a 3-2 bare majority in the Supreme Court in which the minority were so baffled by the argument which ultimately prevailed that one of them described it as incomprehensible, and calculated to make “investment banking more of a lottery than even its fiercest critics have supposed”.

The result of this mess is that it is likely that unsecured creditors will start receiving dividends in LBIE’s administration before the beneficiaries in the client money pool receive anything.

It might be suggested that the interested parties had only themselves to blame for failing to settle their differences. The insolvency and companies legislation provides valuable avenues for compromises and schemes of arrangement designed to achieve exactly that, among large classes of affected stakeholders, and the administrators did their best to travel down that route. Unfortunately, as was held by Blackbourne J and the Court of Appeal, the legislation did not extend to such schemes as between proprietary rather than purely personal claimants: see Re Lehman Brothers International (Europe) [2009] EWHC 2141 (Ch) and [2009] EWCA Civ 1161. Some inroads into this lacuna have recently been made by the Investment Bank Special Administration Regulations 2011 (SI 2011/245) but, alas, too late for Lehman clients.

The second example of a spectacular statutory failure revealed by the Lehman collapse concerns the Financial Support Direction regime in the Pensions Act 2004. It is designed to top up the pension funds available to the staff of the employment service companies in corporate groups which fail with big pension scheme deficits. It was again inspired to some extent by a Euro directive. The regime enables the Pensions Regulator to impose, subject to the supervision of a specialist tribunal, a novel form of order called a Financial Support Direction (FSD) requiring any associated company (the “target company”) to make appropriate contributions to the deficient group staff pension fund. It will usually have more assets (even if insolvent) than the employer service company.

The trouble with the new regime is that the drafter (and therefore Parliament) gave no conscious thought, and therefore made no bespoke provision, about the priority in the target company’s own insolvency between the FSD (designated to benefit pensioners who would not otherwise be its creditors at all) and the claims of what might be thought to be its equally deserving but unsecured creditors, where the FSD is imposed after the onset of the target company’s insolvency process (whether liquidation or administration). The alternative conclusions in the expensive and still unresolved litigation which ensued lie between a pari passu sharing, absolute priority on the basis that the cost of complying with the FSD is a liquidation or administration expense, or the outcome that the FSD is inadmissible to proof at all, thereby falling down a form of black hole.

It was decided at first instance and in the Court of Appeal in October 2011 that the pensions legislator had naively left it to the existing insolvency legislation to resolve this ticklish priority conundrum without asking anyone versed in those matters what the outcome would be: see in Re Nortel GMBH and Lehman Brothers International (Europe) [2010] EWHC 3010 (Ch), [2011] EWCA Civ 1124. It turned on the House of Lords’ decision in re Tohoku Finance plc (in liquidation) [2002] I WLR 671, together with a string of Court of Appeal decisions about the cut-off date for proof of debts in insolvency. However unfortunate and unfair to the creditors, the result was that the FSD liability had complete priority over the creditors’ claims as a liquidation or administration expense.
The final resolution of this impasse awaits the decision of the Supreme Court. Meanwhile the already complex statutory procedure of imposing an FSD and defending it from the target companies’ attack remains stayed. The pensioners and creditors are being forced to endure the resulting uncertainty, so much so that there has not yet (as far as the writer is aware) been a single example of the successful making and enforcement of an FSD since the Pensions Act was passed. The 2004 Act will probably be almost 10 years old before that crippling uncertainty is resolved, or corrected by amendment if the priority outcome is not what Parliament would have wanted if it had thought about it at all in the first place.

These two examples do not reveal the modern process of statutory protection and regulation in anything like a good light. This should not be blamed upon the besotted parliamentary drafters. They necessarily work in a kind of anticipatory vacuum, in which they can only guess at the events which, in the near or distant future, will put their complex but fragile structures under a form of destruction testing. It may not appropriately be a question of blame at all, but just a wry comment on human frailty and the ever-increasing complexity of business life.

**APPEAL MANAGEMENT**

These cases do perhaps reveal a need for some form of fast track (or, as the Americans would say, rocket docket) for the determination of legal issues affecting whole classes of on-going business in the financial markets. In theory there are processes for expediting matters at every level (first instance and appellate), and they can lead to amazingly fast determinations. But in practice this is very rarely achieved, not least because of the lawyers’ desire to leave no stone unturned, the parties’ desire to have counsel of their choice (despite their busy diaries) and parties’ tactical reasons, from time to time, to go slow, eg if they have a first instance judgment in their favour which they do not want to be disturbed. Finally settlement negotiations can perfectly properly stop a case from progressing for significant periods. If settlement ensues, the point of general public importance may never be reviewed at the appellate level at all.

What may be lacking is any level of cradle to grave active judicial case management spanning both first instance and appellate levels, to drive the process on in the public interest, however occasionally reluctant the parties. The court’s occasional readiness to expedite is essentially responsive to intermittent party pressure, rather than pro-active. Furthermore there is almost no case management communication between different levels of court. The initiative for expedition has to start all over again at each level, and has to be party led.

There is the leapfrog option (cutting out the Court of Appeal where a case is bound to end in the Supreme Court) but again it is very sparingly used. It was almost used in the Nortel/Lehman case, but there was one big point that deserved Court of Appeal attention first. In the end, the Supreme Court did not expedite the final appeal, and it is still to be heard.

There is also the difficulty that business cases are in the final analysis about money and property, rather than liberty, life and death, the health and the security of children or of the state. This inevitably leads to other types of case being prioritised for the available attention of our very hard working appellate courts. But the real effects of legal uncertainty on business activity, and the knock-on consequences in terms of economic prosperity and competitiveness may not yet be fully recognised in the competition for speedy hearings. UK plc does very well out of the high international reputation of English law and of those who administer it, both judges and lawyers. But there is no point in having the finest law in the world if its uncertainties take so long to sort out that the determination comes too late to cure the malaise caused by the uncertainty, in the minds of those whose on-going business transactions are thereby undermined. It is an aspect of our national and economic health, and deserves to be prioritised accordingly.

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This article is based on the author’s 2012 Denning lecture to BACFI.

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