



Lehman Brothers

How Can Hedge Funds Get Their Money Out of Lehman Brothers International Europe?

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By Jennifer Banzaca, *Hedge Fund Law Report*

The return of assets to clients of Lehman Brothers International Europe (LBIE) has been a slow, complex process. Administrators for LBIE have applied to the U.K. High Court for approval of a proposed scheme of arrangement (Scheme) intended to facilitate the process of valuing, recovering and returning client assets. (A scheme of arrangement is the analogue in a U.K. administration proceeding to a reorganization plan in a U.S. Chapter 11 proceeding.) See “[Should Hedge Funds Purchase Unsecured Debt of Lehman Brothers Holdings Inc.? Key Legal Issues Impacting Returns](#),” *Hedge Fund Law Report*, Vol. 2, No. 26 (Jul. 2, 2009).

LBIE is the U.K. broker-dealer affiliate of Lehman Brothers Holdings Inc. (LBHI), and served as a prime broker to various hedge funds. On September 15, 2008, LBHI filed a petition in the United States Bankruptcy Court for the Southern District of New York seeking relief under chapter 11 of the United States Bankruptcy Code. Subsequently, 18 additional affiliates of LBHI filed petitions in the United States Bankruptcy Court also seeking relief under Chapter 11 of the U.S. Bankruptcy Code. For more on the LBHI bankruptcy see, “[Lehman Brothers Holdings and Certain of its Subsidiaries File for Bankruptcy Protection](#),” *Hedge Fund Law Report*, Vol. 1, No. 21 (Sep. 22, 2008).

Also on September 15, 2008, LBIE was placed into administration in the U.K. The U.K. court has since appointed several partners of PricewaterhouseCoopers (PwC) as joint administrators of the LBIE estate. When LBIE collapsed, the assets of its hedge fund clients were frozen, and for such hedge funds, retrieving those assets has been a long and tortuous process. Reportedly, some hedge funds have collapsed based on their inability to recover assets frozen at LBIE. Others have had difficulty paying redemptions. And at a minimum, hedge funds with assets frozen at the insolvent broker-dealer have been unable to deploy those assets for investment purposes. To date, PwC has returned about \$13 billion of the \$32 billion in clients assets held at LBIE.

The Scheme is intended to improve and expedite the process of returning assets to affected clients. On July 14, 2009, PwC issued a briefing note (Briefing Note) outlining the key points of the Scheme.

Steven Pearson, one of the joint administrators, said in a statement: “Fundamentally, the Scheme proposes a compromise on all sides to cut through the multiplicity of complex issues to deliver a fair solution. It has the unanimous support of the LBIE creditors’ committee, which contains representatives of both trust clients and general estate unsecured creditors.”

U.K. administrators worked with the creditors’ committee to develop the Scheme. The LBIE creditors’ committee includes managers of Ramius Credit Opportunities Master Fund, GLG

European Long/Short Fund, Legal and General Pensions and Oceanwood Global Opportunities Master Fund, along with LBHI. Owen Littman, General Counsel of Ramius LLC, a member of the LBIE creditors' committee, urged creditors to approve the Scheme, noting that he believes the Scheme "is the best way to address the return of client assets."

While PwC and the creditors' committee support the Scheme as a best among various imperfect options, Ian Harvey-Samuel, a Partner of European Finance at Shearman & Sterling (London) LLP, said the Scheme is an unusual move. The London Investment Banking Association has also stated its opposition to the Scheme. As Harvey-Samuel explained, a scheme of arrangement such as the Scheme generally is made with respect to debt claims, as opposed to claims for return of property such as securities. "This Scheme is so controversial in its basic level because it's so contrary to the basic principle that you own your own property and are entitled to its return. If you give your property to a bank by way of security and then the bank cannot give you back your property, it will end up effectively requiring you to enter into a scheme of arrangement to receive back less than what you gave. It's causing a great deal of debate."

John Ashmead, a Partner at Seward & Kissel LLP, noted that while the proposed Scheme may be unusual, it may be the fairest option for all stakeholders in the insolvency. "While broad insolvency guidelines exist, there's nothing specific to a broker-dealer. So, PwC – within these very broad and unspecific guidelines – is trying to fashion a plan to deal with the LBIE meltdown, which is something that they've never seen."

Scheme Approval

Generally, a scheme of arrangement is a procedure whereby a company makes a compromise or arrangement with its members or creditors in insolvency. During July 29 through 30, 2009, a hearing on the Scheme application took place at the High Court in London. At the hearing, the High Court deferred judgment on the application, but PwC subsequently noted that the High Court is expected to rule on the Scheme application in "late August."

Harvey-Samuel noted that the Scheme has to be approved by (1) the High Court and (2) two-thirds of creditors by value and a 75 percent supermajority of creditors.

Who is Eligible to File Claims?

PwC's Briefing Note states that eligible claimants will include hedge funds that "had a proprietary claim to segregated securities held by LBIE in trust when LBIE went into administration" on September 15, 2008.

According to Ashmead, clients with "segregated securities" include "folks that had prime brokerage agreements with LBIE with assets that were not rehypothecated. These clients can file claims under this proposed Scheme. As an example, say you had hedge fund XYZ that had an account at the commencement of LBIE's administration and the account had \$100 million of securities in the account but \$50 million of those securities were rehypothecated. As I understand what they are proposing, if and when LBIE recovers those securities that were not rehypothecated, they will be returned to hedge fund XYZ. For the \$50 million that were rehypothecated, the fund would just have a general unsecured claim against LBIE under a separate scheme, which hasn't even been proposed yet, and be paid later with whatever is recovered to pay unsecured creditors."

Lawrence Gelber, a Partner at Schulte Roth & Zabel LLP added: “this Scheme is not intended to deal with all of the claims of all creditors of LBIE. It is designed to deal with the claims of those creditors who have proprietary claims to securities being held in trust with LBIE. This applies primarily to customers who had prime brokerage accounts at LBIE and who had deposited securities there.”

Creditors who are eligible to file claims under the Scheme will be required to submit a standard claim form. Ashmead said that if the Scheme is approved, the forms would be distributed to eligible creditors, much like the claim form process in U.S. bankruptcy court proceedings.

Valuing Claims

While the process for determining which creditors are eligible to file claims under the Scheme appears to be relatively straightforward, less certain is how the claims will be valued. The PwC Briefing Note states that if LBIE sold a client’s assets, the value of that client-creditor’s claim will be the sale price. Otherwise, the value would be based on the mid-market value of the assets in the client’s account as of the date of commencement of the administration (September 15, 2008). A fuller explanation of the valuation methodology is outlined in the PwC Briefing Note.

Schulte’s Gelber explained that the value of a claim will depend, in part, on precisely what type of claim a creditor has. Long positions will be valued differently than short positions and rehypothecated securities will be treated differently than those that were not rehypothecated. “What the administrators are proposing is to look at each security that LBIE was holding for customers as of the time of the commencement of the administration. For example, let’s say LBIE was supposed to have had 1,000 shares of IBM stock at the time of the commencement. For whatever reason, the administrators may only be able to find 800 of those shares. What will happen is that the 800 shares will be distributed proportionately among all those customers whose records show that they held IBM stock as of the commencement of the administration,” Gelber noted.

Harvey-Samuel added that under the Scheme, LBIE creditors are expected to make claims for assets, not a monetary amount owed. “For example, creditors are saying they want back 10,000 GE shares, which is a property claim rather than a money claim. What the administrators are doing is dividing and distributing the shares proportionately among those who claim they own those shares. The remainder they are owed becomes an unsecured claim within the general liquidation of LBIE. The unsecured claims will get paid equally with all other unsecured claims.”

Netting

Assuming the court approves the Scheme, affected creditors will vote on whether collateral that had been rehypothecated can be netted. The PwC note does not provide specific guidance on how to deal with netting and those who spoke with the Hedge Fund Law Report said netting has not yet been specifically addressed by the Scheme.

However, the Scheme does provide for set offs, which are rights to cancel mutual debts between two parties in a bankruptcy or similar proceeding. “There will be provisions for set offs where to the extent that LBIE owes money to a customer and the customer owes money to LBIE, customers will be entitled to set off rights,” Gelber noted.

Currency and Tax Considerations

The PwC Briefing Note explained that the Scheme will operate in U.S. dollars and LBIE may withhold tax on distributed amounts. (Tax amounts or rates were not outlined in the PwC Briefing Note.)

While the Briefing Note states that taxes can be withheld, Harvey-Samuel indicated that taxes would not be applicable because under the Scheme, clients would receive their own property back. “Since any disbursements would be deemed a recovery of one’s own property, there should not be any offsetting tax concerns.”

Opt-Out Provision

One provision of the Scheme is an opt-out rider for creditors who wish not to settle their claims under the terms of the Scheme. Creditors that choose to opt out would in effect be treated as unsecured creditors.

As Harvey-Samuel explained, “a creditor may wish to opt out if it had very small segregated asset claims. If you have a small segregated asset claim and a very large financial contract claim, you wouldn’t want your financial contract claim to be determined using the Scheme methodology if that reduced your total claim on LBIE compared to with what it would be under normal law. Say I was Bank of America and I had a large ISDA claim and under my normal contract methodology my ISDA claim would be \$100 million but under the Scheme valuation methodology my claim would only be \$90 million. I’d rather opt out of the Scheme and lose the some assets than lose the \$10 million difference in my valuation closeout.” See generally “[Lehman Debtors Propose Procedures to Unlock Value in ‘In The Money’ Derivative Contracts](#),” Hedge Fund Law Report, Vol. 1, No. 26 (Dec. 3, 2008).

When to Expect Disbursements

PwC noted that if the Scheme is approved by the High Court and the requisite percentage of creditors, those creditors should expect to see disbursements sometime during the first quarter of 2010.

However, Seward & Kissel’s Ashmead said he did not think this timeline is realistic. “I am not sure this is a reasonable timeline since there are a number of issues that need to be resolved, like the \$6 or \$7 billion tied up in the U.S. SIPC proceeding, before they can start returning assets.”

SIPA Proceeding

Since roughly \$6 billion in LBIE assets are currently frozen in the Securities Investor Protection Act (SIPA) proceeding of LBHI, the ability to disburse LBIE client assets to client-creditors is in question. PwC reported that some of the securities of LBIE customers actually were being held at LBHI in New York and there have been ongoing discussions between the administrators in the U.K. and the SIPC trustee regarding if and when some or all of those securities will be returned from LBHI to LBIE.

According to Gelber, “it has been reported that in accordance with Lehman’s consolidated cash management system, LBHI regularly swept funds out of LBIE, only to return the funds to LBIE to permit it to meet its obligations. What LBHI has said is that on the weekend of September 15, 2008, there was a regular sweep, followed by the intervening commencement of LBHI’s Chapter 11, so LBHI was not able to send the money back to LBIE so it could meet its obligations the following Monday morning.”

With so many variables, it has been difficult for the administrators to return assets to creditors in a timely manner. Harvey-Samuel concluded that while the Scheme is unusual, it may offer the fairness and most expeditious avenue for hedge funds seeking to recover assets currently locked in the LBIE estate.

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