

IN THE HIGH COURT OF JUSTICE

No. 7942 of 2008

CHANCERY DIVISION

COMPANIES COURT



In the matter of Lehman Brothers International (Europe) (in administration)

And in the matter of the Insolvency Act 1986

ORDINARY APPLICATION

TAKE NOTICE that Steven Anthony Pearson, Anthony Victor Lomas, Michael John Andrew Jervis, Dan Yoram Schwarzmann and Derek Anthony Howell of PricewaterhouseCoopers LLP, Plumtree Court, London EC4A 4HT ("**Joint Administrators**"), the Joint Administrators of Lehman Brothers International (Europe) ("**LBIE**"), intend to apply to the Judge on:

Date:

Time:



Place: Court 59, Royal Courts of Justice, Strand, London

For directions pursuant to paragraph 63 of Schedule B1 to the Insolvency Act 1986 and for orders as follows.

General principles

1 Where LBIE received or held client money on trust for a client¹ which was credited to a house account:-

- (a) is that client money or any traceable proceeds to be identified by reference to that house account alone or by reference to an aggregate of accounts and, if so, which?

¹ A term used to mean any entity or person who dealt with LBIE and who may be entitled to assert that LBIE received client money on its behalf (including any other company that formed part of the Lehman Group).

- (b) in order to identify that client money or any traceable proceeds, which of the following evidential presumptions should be applied, and how?
- (i) The "first in, first out" basis, as in Clayton's Case [1814-23] All ER Rep 1.
 - (ii) Pari passu, as, for example, in Barlow Clowes International Limited v Vaughan [1992] 4 All ER 22.
 - (iii) The rules in Re Hallett (1880) 13 Ch D 696 and Re Oatway [1903] 2 Ch 35: initial withdrawals from a mixed account are deemed to be made with the trustee's own funds, unless those withdrawals have resulted in a lucrative investment which the client wishes to claim.
 - (iv) The lowest intermediate balance principle enunciated in Roscoe (Bolton) v Winder [1915] 1 Ch 62, and, if so, should the principle be applied by reference to closing (rather than intra-day) balances?
 - (v) Some other presumption and, if so, what?

- 2 How should the identification analysis be conducted in relation to an account in circumstances where it has not been possible to establish, in respect of the period of 2 weeks ending with the commencement of LBIE's administration, the extent to which the sums standing to the credit of the account during that period comprise client and house money respectively?

Bar date

- 3 Any client who maintains that client money was paid to LBIE:-

- (a) prior to 1 September 2008; or
- (b) in the period 1 September to 07.56 on 15 September 2008 and which has not been acknowledged by the Joint Administrators in writing;

in respect of which the client has received no value shall communicate, by a date to be directed by the Court (the "**Bar Date**") and by a specified manner, the following information to the Joint Administrators, namely, (a) the date on which the payment was made, (b) the amount of the payment and (c) the reason for the payment (including identifying and providing a copy of any contract pursuant to which the payment was made).

- 4 The Joint Administrators shall give such notice as the Court shall direct of the Bar Date by:
- (a) placing an announcement on the Lehman section of the PricewaterhouseCoopers LLP website (http://www.pwc.co.uk/eng/issues/lehman_updates.html) (the "**Notice**");
 - (b) publishing the Notice in the Financial Times and the Wall Street Journal.
- 5 If, after the Bar Date has passed, the Joint Administrators procure that LBIE does, and LBIE does:
- 5.1 distribute client money to clients who, on the basis of information available to LBIE and the Joint Administrators at the time of such distribution, are entitled to it; and
 - 5.2 appropriate or distribute such money or assets as, on the basis of the information available to LBIE and the Administrators at the time of such appropriation, legally and beneficially belong to LBIE;

LBIE and the Administrators will not be liable in respect of any breach of trust (whether as trustee or accessory) to any client seeking to maintain a proprietary claim to client money in respect of any additional claims not reflected by the distributions and/or appropriations actually made where, prior to the distributions and/or appropriations being made, LBIE and the Administrators did not have information available to them to support the existence of those additional proprietary claims.

Payments of client money direct to Affiliates

- 6 When clients, at the direction of LBIE, paid money to an Affiliate (which money would have been client money under CASS if received directly by LBIE), did the receipt of money by the Affiliate result in there being client money or some other asset in LBIE's hands, into which money or other asset (or the identifiable proceeds of which) a client might trace value?
- 7 Does the answer to question 6 change in the event that the payment was made at a time when LBIE was a net debtor of the Affiliate?
- 8 What is the scope of the Joint Administrators' duty (if any):-
- (a) in relation to establishing whether any payments made by the Affiliate were payments of client money?

- (b) in relation to vindication of clients' proprietary rights (if any) against the Affiliate or any person to whom that Affiliate paid money?

Identifying specific proceeds

- 9 In what circumstances are payments received or to be received by LBIE in settlement of debts owed by counterparties of LBIE pursuant to "over the counter" and other off-exchange transactions entered into with LBIE prior to its entry into administration the proceeds (or to be treated as the proceeds) of identifiable client money?
- 10 Does the answer to question 9 above turn upon whether value was provided to the counterparty, by whom and in what form?
- 11 In what circumstances are sums standing to the credit of transaction accounts other than client transaction accounts and payments received or to be received by LBIE from clearing houses and intermediate brokers in connection with on exchange transactions executed by LBIE prior to its entry into administration the proceeds (or to be treated as the proceeds) of identifiable client money in circumstances where margin in respect of the relevant transaction was provided on a net basis:
- (i) by LBIE;
 - (ii) by an Affiliate on behalf of LBIE.
- 12 In what circumstances can value be traced by clients from any identifiable money received by an Affiliate (which money would have been client money under CASS if received directly by LBIE) into the hands of third parties to whom the Affiliate paid money other than as addressed in the answers to issues 9, 10 and 11 above?
- 13 If the answer to questions 9, 10, 11 or 12 is that value can be followed in these circumstances, how is the client's proprietary claim to be quantified in circumstances where:-
- (a) the value provided by or on behalf of LBIE was only part of the total value provided pursuant to the contract?
 - (b) the closing balance on the house transaction account (and the amount returned or to be returned to LBIE) was the product of (i) margin provided by or on behalf of LBIE on a net basis for all positions on the account and (ii) the proceeds of closed-out transactions, including transactions referable to the client (the "**Client Positions**"), but (x) no part of that balance (including

margin paid) was identified by LBIE or the relevant clearing house or intermediate broker as being specifically referable to the Client Positions, and (y) transactions were closed out at prices and in a manner beyond LBIE's control?

- 14 To what extent, if at all, is the answer to question 13 affected by the following factors:-
- (a) an agreement, assumption or understanding that money would not be segregated by LBIE for a particular client (for a reason other than a total title transfer arrangement)?
 - (b) LBIE not calling for payment of margin from a particular client?

Applicable law

- 15 When assets into which clients may wish to attempt to trace value are situated outside England, which law governs whether the property is traceable and/or whether the current holder of the assets has a defence to a recovery action?

Credits pursuant to the Liquidity Management Process ("LMP")

- 16 In what circumstances should payments made by LBHI to LBIE as part of the LMP be treated as the proceeds of identifiable client money? Specifically, is appropriation a necessary requisite? If so, in what, if any, circumstances, should appropriation be deemed to have occurred?

Assumptions

- 17 What assumptions are the Joint Administrators entitled to make in their analysis of whether particular sums of client money or the proceeds of those sums remain identifiable?

Case management orders


- 18 The Administrators' costs, fees and expenses of and occasioned by this application be paid:
- (a) as an expense of the administration; or
 - (b) from client money subject of the statutory trust; or
 - (c) in part as an expense of the administration and in part from client money subject of the statutory trust;

in such proportions as shall be ordered by the Court, and/or that such other order may be made as to the incidence of the Administrators' costs, fees and expenses of this application as the Court thinks fit.

19 Such further order or relief as the Court thinks fit.

Dated this 8th day of April 2011

Signed:


Partner

Solicitors for the Applicant:

Linklaters LLP

Address for service:

Linklaters LLP

One Silk Street

London

EC2Y 8HQ

Ref: Satindar Dogra/Stephen Fletcher

Notice of this Application has been given to the Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS

It is not intended to serve any person with this Application.

If you do not attend, the Court will make such order as it thinks fit

Applicants
A P Clark
Seventh Statement
"APC 7"
8 April 2011

IN THE HIGH COURT OF JUSTICE

No. 7942 of 2008

CHANCERY DIVISION

COMPANIES COURT

**IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in
administration)**

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

**SEVENTH WITNESS STATEMENT OF
ANDREW PETER CLARK**

I, ANDREW PETER CLARK, of PricewaterhouseCoopers LLP, Plumtree Court, London EC4A 4HT, state as follows.

A. INTRODUCTION

- 1 I am a partner in PricewaterhouseCoopers LLP ("**PwC**"), a firm of accountants at the above address. I am one of the partners assisting the joint administrators of Lehman Brothers International (Europe) ("**LBIE**") (in administration) and am responsible for the client money work stream in LBIE's administration (the "**Administration**").
- 2 My partners, Steven Anthony Pearson, Anthony Victor Lomas, Michael John Andrew Jervis, Dan Yoram Schwarzmann and Derek Anthony Howell are the joint administrators of LBIE (the "**Administrators**") who were appointed as such by order of Mr Justice Henderson on 15 September 2008 (save for Derek Anthony Howell, who was appointed as an additional joint administrator of LBIE on 30

November 2009). I am duly authorised to make this witness statement on behalf of LBIE and the Administrators.

- 3 Where there is no other indication of the source of my information or belief, the contents of this witness statement are derived from facts and matters which are within my own knowledge and belief. These facts and matters have been learned either as a result of the work undertaken by me in assisting the Administrators of the 20 Lehman companies in administration in the UK (referred to in this statement as the "**Lehman Administration Companies**"), or they have been provided to me by the Administrators, my partners and colleagues at PwC involved with the administration of the Lehman Administration Companies, by the employees of the Lehman Administration Companies who are still available to the Administrators, or by the Administrators' legal advisers, Linklaters LLP ("**Linklaters**").
- 4 I make this statement in support of an application (the "**Application**") for directions which concerns (among other things) the legal principles to be applied to identify and trace client money¹. This is my first statement in support of this Application and my seventh statement in these proceedings.
- 5 The remainder of this statement is divided into 5 sections:
 - 5.1 Section B outlines the background to the Application;
 - 5.2 Section C sets out the legal issues for determination;
 - 5.3 Section D summarises the context in which the Application is made;
 - 5.4 Section E summarises briefly the factual background; and
 - 5.5 Section F discusses procedural matters relating to the Application.

B. BACKGROUND TO THE APPLICATION

- 6 As the Court will be aware, the Administrators issued an application on 1 May 2009 seeking directions from the Court concerning LBIE's obligations in relation to the handling of client money received prior to the time of Administration (the "**Client Money Application**"). Mr Justice Briggs ("**Briggs J**") handed down judgment on the Client Money Application on 15 December 2009 and 20 January 2010. Four parties

¹ As should be clear from what follows, this Application relates to client money (if any) held by LBIE in its house accounts (as defined in paragraph 7 below) and is not concerned with client money held in bank accounts used exclusively by LBIE in order to segregate client money (including client money deposited with Lehman Brothers Bankhaus AG) (such accounts are referred to in this statement as LBIE's "**core client money bank accounts**" in accordance with the definition adopted in the Client Money Application).

appealed and, following a four day hearing in June 2010, judgment on the appeals was handed down by the Court of Appeal on 2 August 2010.

- 7 The Court of Appeal agreed with Briggs J that identifiable client money held in **LBIE's house accounts**² did not belong to LBIE's general estate. However, whereas Briggs J had found that identifiable client money in those accounts should be returned to the client for whom it was held, the Court of Appeal found that client money in LBIE's house accounts formed part of the client money pool (the "**CMP**").
- 8 On Briggs J's analysis, and as he observed at paragraphs 192, 193 and 197 of his judgment, it is likely that unsegregated clients would face difficulties tracing client money which was held outside of LBIE's segregated accounts, particularly if the burden lay upon LBIE's clients (rather than LBIE) to identify such property through the established techniques of tracing.
- 9 The Administrators submitted before the Court of Appeal that it would be extremely difficult for the Administrators to identify client money in LBIE's house accounts unless they were put on enquiry (whether by LBIE's records or by a client with a supported claim) that a particular receipt of client money had not been segregated. On that basis, the Administrators took the view that it would not necessarily be easier for them (as opposed to a LBIE client) to identify client money in LBIE's house accounts.
- 10 The Court of Appeal disagreed with this submission and indicated (obiter) that the Administrators would be better placed to identify client money held outside LBIE's segregated accounts. Specifically, Lady Justice Arden commented at paragraph 122 of the Court of Appeal judgment that: "*The task for the Administrators may be difficult but not as difficult as that facing clients with individual tracing claims as a whole*".
- 11 Whilst the Court of Appeal declined to give directions on the question of burden of proof in relation to tracing, indicating that such issues were a matter for further directions from this Court, it would seem to follow from the analysis of Lady Justice Arden that it falls upon the Administrators to take reasonable steps to identify client money held in LBIE's house accounts so as either to add it to the CMP or, in the event that the Supreme Court overturns the decision of the Court of Appeal and reverts to the judgment of Briggs J, to return it to the relevant client.

² A term used to mean any account other than LBIE's core client money bank accounts (and which, it follows, covers the following two categories of account as described in the context of the Client Money Application, namely the "non-core client money bank accounts" and LBIE's "house accounts").

- 12** The Court of Appeal has not provided any guidance as to what principles should be adopted when undertaking the tracing exercise³. I understand that the tracing rules are complex and the demise of LBIE poses difficult questions concerning the application of the tracing rules in this context. In light of this and given that the sums at stake are potentially very substantial, the interpretation and application of the equitable tracing rules is likely to prove contentious. Accordingly, the Administrators have made the Application to seek guidance from the Court in respect of the issues identified to date, further details of which are set out in Sections C and D below.
- 13** This Application is important and integral to the progress of the Administration. As this Court has been made aware during the Administrators' application on 10 December 2010 to postpone the date by which proofs of debt may be lodged, a major factor affecting the Administrators' ability to declare a dividend to all or a portion of LBIE's unsecured creditors is establishing whether or not certain funds currently credited to LBIE's house accounts constitute client money. Until this issue is resolved, they may not be in a position to declare a meaningful dividend.
- 14** The decision of the Court of Appeal is the subject of an appeal to the Supreme Court. It is anticipated that the Supreme Court will hear the appeal at the end of October 2011. This Application proceeds on the basis of the Court of Appeal's finding that client money is held on trust from receipt (and not merely from the point at which it is segregated), as both Briggs J (paragraphs 141 to 165 of the judgment) and the Court of Appeal (paragraphs 104, 177, 203 and 239 and 243) held. That finding is under appeal to the Supreme Court. If the Supreme Court overturns the Court of Appeal's finding in relation to this issue, many of the issues raised in this Application will fall away. However, if no steps are taken to advance the identification analysis until such time as the determination of the Supreme Court is available, there is a very real risk that a year or more may pass without the Administrators having made progress towards returning client money and making a meaningful distribution from the general estate. The Administrators' desire to make progress is a matter which has been canvassed with the creditors' committee, and, as a result of the discussions with the members of that committee, there is an expectation on the part of the creditors of the general estate that the Administrators will take steps to commence the Application as soon as possible. The Court is,

³ For the purposes of this statement I use the term "tracing" as shorthand for the process of identifying, following and tracing client money.

therefore, asked to consider the issues raised on the basis that client money is held on trust from receipt⁴.

- 15 It will only become necessary to undertake a tracing exercise to the extent that it is established that identifiable client money was paid into LBIE's house accounts and was not segregated or returned to a client.
- 16 As I explain in further detail below, the Administrators are currently reviewing payments into and out of LBIE's house accounts to identify client money held in LBIE's house accounts. This process is ongoing and it is not clear at this stage of the Administrators' investigations what (if any) client money LBIE is holding in its house accounts.

C. ISSUES ON WHICH DIRECTIONS ARE SOUGHT

- 17 The Administrators and their advisers have identified various issues which require determination in order to: (i) enable them to return client money to clients or, as the case may be, to identify client money which forms part of the CMP; and (ii) determine which funds credited to LBIE house accounts do not constitute client money so that they can be released to the general estate for distribution to LBIE's unsecured creditors. The directions sought by the Administrators are set out in the Application Notice dated 8 April 2011 (the "**Notice**"⁵) which is exhibited to this witness statement at pages 1 to 7 of Exhibit APC 7.
- 18 As should be clear from the Notice, the directions are focused on tracing and identification issues. However, the question raised at paragraph 14 of the Notice considers the nature of the relationship between LBIE and its **Affiliates**⁶ in the context of considering whether otherwise applicable tracing rules should not apply in respect of Affiliates. I understand that it may be argued that determination of this specific issue is a question of client money entitlement and does not therefore fall to be decided as part of the Application. The Administrators do not agree with the characterisation of the issue in this way; when deciding whether to apply tracing principles, one must ask whether the relevant property belongs beneficially to someone in the particular circumstances. That necessarily involves entitlement

⁴ I am advised that there may be an additional benefit in the parties to the Client Money Application having sight, and understanding the nature, of the directions sought in the Application, in case it has any bearing on arguments they wish to put before the Supreme Court.

⁵ The directions refer to money being held by "a client". The use of that term in the Notice and this witness statement is intended to capture any entity or person who dealt with LBIE and who may be entitled to assert that LBIE received client money on its behalf (including the Affiliates unless stated otherwise).

⁶ I use the term Affiliate in this statement to refer to the other companies that formed part of the Lehman Group (as defined in paragraph 26 below).

issues. Moreover, Affiliate client money claims are most likely to focus on the money held in respect of exchange-traded margined derivative transactions. Detailed evidence about these complex transactions will in any event be required on the Application. The Court may, therefore, take the view that it would be convenient to resolve all issues pertaining to these transactions at one hearing, so as to avoid the time and costs of further proceedings arising out of the same transactions and involving the same parties. Accordingly, the Administrators invite the Court to consider including, in the list of issues to be determined on this Application, the question set out at paragraph 14 of the Notice.

- 19 Whilst it is hoped that the directions sought encapsulate all of the relevant issues it may be necessary to amend or supplement the directions as the Administrators continue to investigate these matters further⁷.
- 20 I explain the context in which the directions are sought in Section D below. Given that factual investigations are ongoing it is not possible for the Administrators to reach a definitive view on the issues raised at this stage. The Administrators will, in due course, set out their position in detailed submissions (and it is suggested that the most effective manner in which to do so is by way of position papers). I have, nonetheless, sought to draw some tentative conclusions on the basis of the work carried out to date in order to assist the Court. To the extent I do express a view on behalf of the Administrators, it should be clear from what follows that the Administrators' position is based on their current understanding and the views expressed herein may change in due course.
- 21 The purpose of this witness statement is to provide a high level overview of the directions sought and a brief explanation of the investigative work completed to date by the Administrators. The Administrators intend to produce detailed witness evidence in due course which will address the various aspects of the Application (including the approach taken in the investigation work which has been completed), further details of which are set out in Section F below.

D. THE CONTEXT IN WHICH THE DIRECTIONS ARE SOUGHT

- 22 In the following paragraphs I consider the context in which the directions are sought. For ease, I adopt the general headings used in the Notice. I have sought to give colour to the issues by selecting simple examples informed by the nature of LBIE's business but without descending into the complexities of how LBIE

⁷ In addition, respondents to the Application (as to which see paragraph 108 below) may wish to amend or supplement the directions as the Application progresses.

organised its affairs, which is, in any event, likely to impact on more than one of the issues set out in the Notice. I have set out, in high level terms, some information about LBIE's specific circumstances in Section E, under the heading "Factual Background".

General Principles

Account-by-account or omnibus?

- 23** The question posed at paragraph 1(a) of the Notice is concerned with determining whether the identification of client money received by LBIE is to be undertaken on:
- 23.1** an 'account-by-account basis', i.e., following a receipt into a particular account and then determining whether that money is still in that account; or
- 23.2** an 'omnibus basis', i.e., following a receipt into any LBIE bank account and then determining whether, in aggregate across all of LBIE's bank accounts, that money is still there.
- 24** I am advised by Linklaters that, as a matter of general law, bank accounts are distinct and are to be treated as such, but that in certain limited circumstances a Court may order the aggregation of bank accounts, such that a common fund is created to which all contributors may stake a claim.
- 25** The practical significance of aggregation can be illustrated by reference to an overdrawn account. I am advised that a right to follow and then assert a proprietary claim over money in a specific account will ordinarily be lost where the account into which the money has been paid is, or becomes, overdrawn. By way of example, say I paid £10 (to which I retained beneficial, but not legal, title) into a LBIE bank account and the following day the same account became overdrawn. According to general equitable principles, I would not be able to assert a proprietary claim over any money which might subsequently be deposited into that account. However, I understand that aggregating bank accounts can produce a different result because funds in separate bank accounts may effectively be treated as one "pot" of cash. Using the example above, if I paid £10 into LBIE's account 1 with Bank X and LBIE had an additional account 2 with Bank Y with a credit balance of £100, the fact that account 1 subsequently became overdrawn would not be fatal to my tracing claim. Provided that, on an aggregate basis, the bank accounts remain in credit (which in this case they should because of the £100 in account 2), I would be able to follow my £10 into the collective pot of cash in accounts 1 and 2.

- 26 This issue is raised because Lehman Brothers Inc. (“LBI”) has indicated, in submissions made in the course of the Client Money Application, that, as a result of the Lehman Brothers Group of Companies’ (collectively the “Lehman Group”) cash management system (termed the liquidity management process, or “LMP”), all of LBIE’s accounts should be treated as one account for tracing purposes. I do not know if LBI will put the argument more widely, in order to seek to bring into account assets other than sums standing to the credit of bank accounts. If so, it may be necessary to revisit, and widen, the terms of the direction.
- 27 The LBI argument is predicated on the basis that it would be wrong to draw a distinction between bank accounts if a firm (in this case LBIE) applies a liquidity management process across all of its house accounts.
- 28 I am advised that the use of a liquidity management process should not in itself be a determinative factor in establishing whether a firm’s bank accounts should be aggregated for tracing purposes. There is nothing unusual about a European subsidiary moving funds to, and receiving funds from, its US parent. Corporate groups often operate a treasury system which has some degree of centralisation in order to ensure that funds are managed across the group in the most efficient way. The fact that funds were transferred to or from a parent company each day does not demonstrate that LBIE operated its bank accounts as an indiscriminate single pot. It will be necessary to consider how the LMP operated in practice before it is possible to reach any conclusions as to how LBIE treated its bank accounts.
- 29 The operation of the LMP is, therefore, likely to be a central issue in this Application. I set out the Administrators’ current understanding of the LMP in very high level terms at paragraphs 85 to 102 below.
- 30 I am advised by Linklaters that the aggregation of bank accounts for tracing purposes has only been allowed in a small number of exceptional cases, for example where there has been fraudulent behaviour by the trustee. The standard approach is that equitable following and tracing rules are applied on an ‘account-by-account basis’. I am not aware of any fraudulent behaviour in this instance and, to date, I am not aware of any facts which, I am advised, would justify a departure from the standard approach. Moreover, the available evidence reviewed thus far does not support the contention that LBIE treated all of its bank accounts as one pot of cash or adopted an indiscriminate approach to its funding requirements. I consider this further at paragraphs 90 to 102 below.

- 31 On the basis of the information currently available, the Administrators therefore believe that LBIE's accounts should not be treated as a single fund for tracing purposes.
- 32 Notwithstanding the above, if the Court was to conclude that LBIE's accounts should be aggregated for the purpose of tracing client money, the Administrators require directions as to which of LBIE's accounts should be aggregated. The Administrators raise this point because during the course of their investigations it has become clear that certain LBIE accounts do not appear relevant for the purposes of identifying client money (for example because they were not used to handle client money).

Evidential presumptions

- 33 I am advised by Linklaters that the evidential presumptions to be applied in order for the Administrators to identify client money or any traceable proceeds can have a significant impact upon a beneficiary's claim and may be the subject of considerable debate. A detailed consideration of the various cases and evidential presumptions referred to in paragraph 1(b) of the Notice is outside the remit of this witness statement. However, I consider a number of factors below that have come to light during the course of the investigations carried out by my team which may impact upon the approach to be adopted.
- 34 The Administrators anticipate that it will be very difficult (at least in respect of those accounts where there was a high volume of transactions) to determine the point in time intra-day at which payments were made into or out of accounts (an exercise known as "**time stamping**" a payment). This information is not shown on LBIE's bank statements, which do not detail the point in time at which a payment was received. In some instances it is possible to use information contained in the relevant SWIFT message to ascertain when a payment was received. Such details are not available in respect of every payment. It may not be possible to ascertain this information by other means; a number of agent banks are proving slow to cooperate with the Administrators and provide the information which would enable the Administrators to undertake a time stamping exercise and, in some cases, such information may not be available. The Administrators are continuing their investigations but it may prove impossible to determine the exact time during the day when funds were received into or paid out of LBIE's house accounts. If that is the case, it follows that it may not be possible to determine when a particular client's funds left an account, or whether a client's funds were used to purchase a particular

asset, and that applying the evidential presumption in Clayton's Case may be unworkable. An additional complexity concerns when an agent bank physically receives payment. This is often different from the date of receipt according to the bank statement.

- 35 The issue of time stamping is also relevant to the question of when an account became overdrawn. It is possible that a large payment made during the course of a day rendered an account overdrawn and a subsequent receipt received later in the day brought the account back into credit. The direction at paragraph 1(b)(iv) of the Notice seeks confirmation that if, as seems likely with respect to most of the accounts, a running intra-day balance cannot be established, the Administrators are entitled to rely on closing balances for the purposes of the lowest intermediate balance principle. I am advised that problems of this type are not novel and that there is some precedent for the use of closing balances rather than intra-day balances.
- 36 In relation to paragraph 1(b)(iii) of the Notice, the Administrators are concerned about the prospect of clients attempting to trace into an asset acquired by LBIE rather than claiming cash in the relevant account (especially where there is sufficient cash in the account to meet the client money claim) simply because the asset may have increased in value compared to the cash used to purchase it. This would require the Administrators to undertake further time consuming investigations into whether funds from the account could be traced into an asset now held by LBIE even in situations where sufficient cash exists in the account to satisfy the claim. Accordingly, where the Administrators have located sufficient client money in the relevant LBIE house account, they will argue that the burden of proof must be on the client to demonstrate that his cash is no longer in the LBIE house account and was instead used by LBIE to purchase an alternative asset.
- 37 The question posed at paragraph 2 of the Notice relates to the investigations that the Administrators have undertaken to determine what (if any) client money is held by LBIE in its house accounts.
- 38 The Administrators initially decided to review those transactions that took place during the two week period immediately before the date of Administration in order to determine how practicable it was to identify client-related receipts in LBIE's bank accounts. This exercise, referred to in this statement as the **payment flow analysis**, has proved to be a huge task and I give some more information about it in Section E below. LBIE's books and records showed that it had in excess of 800

bank accounts and approximately 390,000 cash transactions took place during that two week period in the accounts reviewed and this figure may increase as the Administrators continue their investigations into LBIE's bank accounts.

- 39 Our review to date indicates that some 81 accounts remained in credit throughout the whole two week period (the “**in credit accounts**”). It appears that a number of these accounts have been in credit for many months.
- 40 I am told that the in credit accounts pose some difficulties from a tracing perspective because a tracing exercise should begin from the point at which the composition of a bank account is known (i.e. the point at which the balance was either zero or the balance can be categorically determined as comprising house, trust or co-mingled funds and if so, in what proportions). It is not clear whether it will be possible, in relation to each in credit account, to identify a point in time at which the composition of the account balance can definitively be established. It should be permissible, however, to make some assumptions because the longer the period between the receipt of client monies and the date of Administration, the more likely it is that clients will have received value for such funds or the funds will have been segregated. What seems clear is that, if it is possible, establishing the composition of the balance of the in credit accounts will require significant investigation. It has taken many man months of effort to determine what client money (if any) LBIE is holding in respect of the two week period under review and the analysis is still far from complete.
- 41 The Administrators therefore suggest that they should be able to specify a date before which analysis of receipts may be regarded as too unlikely to yield traceable unsegregated client money to justify the cost of such investigation. Unsegregated client money received close to the date of Administration is clearly more likely to remain traceable than client money received in earlier periods. It is not commercially sensible or desirable to incur significant time and costs investigating receipts and payments that date back months and years before LBIE's entry into Administration. The Administrators have incurred significant time and cost investigating payments in the two week period under review. Investigations beyond that date will require further time and costs and may not result in the identification of any client money. On that basis, the Administrators believe that they should be entitled to limit their investigations to those transactions that occurred between 1-15 September 2008. In respect of payments prior to 1 September 2008, the Administrators consider that it is reasonable to require any client asserting a claim

to client money arising before that date to help facilitate their investigations by putting them on notice and providing details of the alleged payment of client money to LBIE. I expand on this suggestion under the “Bar Date” heading below.

- 42 To the extent that there is a shortfall in any of the in credit accounts, then the Administrators will need to undertake a tracing exercise on behalf of LBIE’s clients and apply established evidential presumptions as directed by the Court as best they can.

Bar Date

- 43 There is a risk that specifying a date before which analysis of receipts may be regarded as too unlikely to yield traceable unsegregated client money means that payments of client money received before that date will not be picked up. In such circumstances, the use of a bar date as envisaged in paragraphs 3 to 5 of the Notice seems the most sensible way (at this stage) of ensuring that potential claimants are not disadvantaged. Accordingly, the Administrators suggest that those clients who maintain that they did not receive value for payments made prior to 1 September 2008 and who therefore believe that they are entitled to client money protection should be required to put the Administrators on enquiry by providing details of: (a) the date on which the payment was made; (b) the amount of the payment; and (c) the reason for the payment (including identifying and providing a copy of any contract pursuant to which the payment was made). Upon receipt of such information, the Administrators will be able to carry out a focused investigation to determine if the payment did constitute client money and if so, what has since become of it.
- 44 The bar date proposal is not limited to payments of client money made before 1 September 2008. It is possible that certain LBIE clients may not agree with the Administrators’ conclusions regarding their entitlement. For example, clients may dispute whether they have received value for a payment of client money made after that date. The Administrators believe that any such issues are best dealt with by applying a bar date. If a client believes that it has made a payment of client money to LBIE which has not been recognised by the Administrators, then it should fall to the client to provide the information referred to above. At this point the Administrators will be in a position to carry out further investigations to determine if the claim is valid. Absent some form of bar date for client money claims, it will be difficult for the Administrators to obtain a complete understanding of the population

of client money claimants and the assets held in respect of such claims in order to be in a position to:

- 44.1 release house funds to the general estate for the purpose of making a distribution to unsecured creditors; and
- 44.2 make a distribution from the CMP (assuming that the Court of Appeal decision is upheld).

Payments of client money direct to Affiliates

- 45 LBIE often directed its clients to pay money to the UK branch of Lehman Brothers Holdings Inc (“LBHI UK” and “LBHI” respectively). In some instances such payments could have involved payments of money by LBIE’s clients to LBHI UK which in turn could have been transferred to the New York branch of LBHI (“LBHI NY”) as part of the LMP. These payments may have been regarded as client money had they been paid directly to LBIE (or if they are now, pursuant to the Court’s direction, to be regarded as having been received by LBIE).
- 46 In the months leading up to, and at the time of the Administration, LBIE was generally a net debtor of LBHI. My understanding is that, for regulatory reasons, LBIE sought to maintain a net payable position towards LBHI and certain other Affiliates. To ensure that this was the case, LBIE sought to maintain a buffer of around US\$1 billion. The Administrators have reviewed the month end intercompany balances from November 2007 to August 2008. Based on the investigations completed to date, I understand that, at month end, a payable was always due from LBIE to LBHI save in respect of March 2008, where a small payable was due from LBHI to LBIE. The Administrators have also reviewed daily intercompany balances for the period 1 September to 12 September. This review suggests that in some limited instances, a payable was due from LBHI to LBIE (although at the time of Administration, a large payable was due from LBIE to LBHI). The Administrators continue to investigate this issue.
- 47 I understand that when LBHI received a payment from a LBIE client, it made a corresponding entry in its intercompany account with LBIE so that LBIE’s indebtedness to LBHI was reduced accordingly.
- 48 The questions posed in paragraphs 6 and 7 of the Notice seek to determine if the payment of client money directly by a LBIE client to LBHI represents an asset in LBIE’s hands into which a client might be entitled to trace value in a situation where LBIE was in fact indebted to LBHI when the payment of client money took place.

- 49 Given that the payment of client money served only to reduce LBIE's overall indebtedness to LBHI, it is difficult to see what property LBIE can be said to have acquired, and be holding, as a result. I am advised that tracing and following are legal processes intended to sustain a proprietary claim. If it is correct that LBIE neither acquired nor held property by reason of the payment, it is difficult to see on what basis the clients in question could assert a proprietary claim against LBIE.
- 50 The purpose of the question posed in paragraph 8 of the Notice is to determine what steps the Administrators must take to ascertain whether there are viable tracing claims against Affiliates and, to the extent that such claims exist, what, if anything, needs to be done by the Administrators to pursue those claims on behalf of clients. In respect of the direction at paragraph 8(b) of the Notice, it is important to note that because the Administrators do not have access to LBIE's Affiliates' books and records, they cannot determine if a payment by an Affiliate was made using money received by an Affiliate from a LBIE client.
- 51 Given the difficulties described, the Administrators seek directions as to the nature and scope of the investigations they must undertake to determine if a payment made by an Affiliate (be it on LBIE's behalf or not) was made using money from a LBIE client.
- 52 In addition, I am advised by Linklaters that many payments to third parties are unlikely to be recoverable because of the availability of the bona fide purchaser defence for innocent third party recipients⁸.
- 53 Whilst the vast majority of payments of money by clients to Affiliates were to LBHI, the Administrators have also found evidence of a limited number of occasions on which LBIE clients paid money directly to other Affiliates. The Administrators are currently investigating the circumstances of these payments.

Identifying specific proceeds

- 54 LBIE has recovered significant sums of money following its entry into Administration from a number of its counterparties and various clearing houses. There are three different categories of proceeds in respect of which the Court's direction is sought.

⁸ I am advised that as a general rule a beneficiary may not bring a claim against the recipient of trust property in circumstances where the recipient acquired such property for value, in good faith and without notice of breach of trust at the time he acquired the trust property.

Debtor settlements

- 55 The question at paragraph 9 of the Notice is concerned with the extent to which clients can trace into payments received by LBIE from counterparties to “over the counter” or other off-exchange transactions (referred to collectively as “**OTC transactions**” in this statement) to settle debts owed by those counterparties to LBIE in respect of OTC transactions⁹ entered into with LBIE prior to its entry into Administration (“**Debtor Settlements**”). On-exchange transactions are addressed separately in paragraph 11 of the Notice. I am advised that if client money was used to pay counterparties under the relevant OTC transaction, then clients may be able to trace into the proceeds of those OTC transactions.
- 56 LBIE has recovered Debtor Settlements in relation to a number of different types of transactions typically executed by LBIE with counterparties pursuant to ISDA Master Agreements, Global Master Repurchase Agreements and Overseas Securities Lender’s Agreements. Work to recover and finalise Debtor Settlements continues.
- 57 The Administrators established a “Debtor Settlements team” to investigate the Debtor Settlements received by LBIE in order to establish the extent to which such settlements were traceable proceeds of client money. In broad terms, the review of the Debtor Settlements recovered by LBIE involves the team identifying any cash or collateral payments made to counterparties to OTC transactions by or on behalf of LBIE and the bank accounts from which such payments were made.
- 58 A number of issues may impact upon the response to the question posed in paragraph 9 of the Notice in relation to Debtor Settlements. I consider these briefly below.
- 59 I am advised by Linklaters that the value of any client money paid by or on behalf of LBIE to a counterparty may not be able to be traced into the hands of those counterparties because of the bona fide purchaser defence considered above.
- 60 Further, the entity making any required payments to the counterparty was generally not LBIE, but an Affiliate on LBIE’s behalf, which may impact upon the ability to trace into a Debtor Settlement. In the majority of cases reviewed by the Debtor Settlements team to date, the Affiliate which made the payment to the counterparty was LBHI. As I have explained, the Administrators do not have access to LBHI’s books and records, so it is not possible to match any payment of client money from

⁹ i.e. a transaction between LBIE and a client, e.g. a swap.

LBIE to LBHI (or of any money paid directly from clients to LBHI) with LBHI's subsequent payment to the counterparty to the OTC transaction. In any event, it is unlikely, because of LBHI's participation in the LMP that such matching transactions actually took place. The same considerations may well apply where payments to the OTC transaction counterparty were made by other Affiliates which may have received client money from LBIE.

- 61 As I have noted, LBIE was generally a net debtor of LBHI. As such, payments by LBHI (on LBIE's behalf) increased the debt owed by LBIE to LBHI, with the result that, quite apart from the evidential difficulties involved, there was no property arising out of that relationship which might now be traceable.
- 62 The Administrators have identified various other scenarios and factors that may impact upon the question posed and potentially lead to different conclusions for different categories of transactions. For instance, where no payment was made by or on behalf of LBIE to a counterparty (for example under a swap where no payments fell due from LBIE pre-Administration), it seems extremely unlikely that the settlement proceeds received post-Administration could be considered to represent the proceeds of client money. The Administrators will provide further details of the types of transactions being analysed as part of the Debtor Settlements team's work in due course.

On exchange transactions and transaction accounts

- 63 The question posed at paragraph 11 of the Notice is primarily concerned with balances recovered (or being recovered) by the Administrators on accounts maintained by LBIE with clearing houses and third-party brokers in relation to exchange-traded margined derivatives transactions, in other words, futures and options ("ETDs").
- 64 LBIE traded in ETDs for its own account, for the account of its clients and for the account of Affiliates (for themselves and, in the case of LBI, for underlying customers). LBIE's arrangements for trading ETDs were complex and I do not propose to discuss these in detail in this statement. For present purposes, I simply note that the balances on the transaction accounts in question fall into two basic categories.
- 65 The first category relates to balances on client transaction accounts, i.e. accounts that related to LBIE's trading for the account of its clients. As I have explained in my first witness statement in the context of the Client Money Application, consistent

with the requirements of the Client Assets Sourcebook (“**CASS**”), LBIE treated the balances on its designated client transaction accounts as being segregated client money for the purposes of its daily reconciliation and segregation exercises. The direction sought in the present Application is not concerned with these accounts.

- 66** The second category relates to balances on the other transaction accounts that LBIE maintained. It is in relation to the balances on these accounts that the Administrators seek direction as to whether any part of those balances comprises client money or its traceable proceeds. In total, there are 19 accounts that are relevant to this direction and I refer to all of them as “**LBIE’s house transaction accounts**” in this statement.
- 67** The balances contained in LBIE’s house transaction accounts relate to LBIE’s proprietary positions, and typically positions opened by LBIE relating to its Affiliates (for themselves and in the case of LBI, for underlying customers¹⁰). In addition, some clearing houses did not permit LBIE to open a segregated client transaction account for client-related trading, in which case client trading was also reflected in the balance on the relevant house transaction accounts. When this was the case, LBIE’s segregation system was meant to ensure that any money needing to be segregated as client money for that client trading was segregated in a client bank account¹¹.
- 68** All positions in LBIE’s house transaction accounts have now been closed out and, as noted above, the balances on the accounts have mostly been returned to LBIE. The sums involved are significant. It is essential, therefore, that the Administrators establish whether such balances contain client money or its traceable proceeds so as to determine whether these funds can be released to the general estate or should form part of the CMP.
- 69** It is believed that the resolution of this issue will turn on whether the money recovered by LBIE represents the proceeds of traceable client money given to the relevant clearing house or broker, or is otherwise the proceeds of positions in which the relevant clients or Affiliates can assert some proprietary interest.

¹⁰ LBIE did not segregate money in client bank accounts for some trades undertaken by LBIE on behalf of some of the underlying customers of LBI.

¹¹ Positions held in LBIE house transaction accounts attributable to LBIE’s non-Affiliate clients (and three LBIE accounts maintained for non-Affiliate customers of LBI) were segregated in LBIE’s core client money bank accounts in the last client money segregation performed on 12 September 2008 using data from the close of business on 11 September 2008.

- 70** LBIE typically required non-Affiliate clients to provide margin to support their positions with LBIE. The client:
- 70.1** funded the opening of a new position by making a one-off initial payment (known as “**initial margin**”) to LBIE (either by making a cash payment or by allocating excess cash on its account with LBIE) – this was essentially to cover the prospect of a decline in the value of the client’s position on default; and
 - 70.2** was required to make further payments to cover any unrealised losses (calculated mark to market, on a daily basis) accruing on positions (known as “**variation margin**”) which were not otherwise covered by movements or excess cash held on the client’s account¹².
- 71** The non-Affiliate client’s positive “equity balance” (which included payments of initial margin and variation margin) would have been segregated by LBIE as client money.
- 72** In contrast, LBIE did not generally require margin to be transferred to it by Affiliates (except with respect to trading for LBI’s underlying customers). The position between LBIE and its Affiliates was dealt with as part of the Lehman Group accounting procedures, further details of which will be provided in due course.
- 73** In relation to its proprietary positions and the client-related and Affiliate-related positions that LBIE opened with the clearing house or broker, LBIE was also required to pay margin to the clearing house or broker. It did so on the portfolio of trades credited to the relevant house transaction account(s) as a whole, meaning that LBIE’s margin requirement was calculated across all of the positions which it had at any particular time on its house transaction account(s) with the relevant clearing house or broker. As a consequence, both initial and variation margin requirements would have been calculated by reference to the aggregate of relevant proprietary, Affiliate-related and client-related positions. This aggregation had the result of netting initial and variation requirements across the portfolio, such that the actual margin required of LBIE to support those positions was materially different from the underlying margin requirements that would have arisen for particular positions within the house transaction account. In other words, margin payments were not (and cannot now be) identified as being referable to specific positions and their associated balances on a particular LBIE house transaction account. This

¹² A margin call would not, for this reason, necessarily be equal to the amount by which a position had fluctuated in value.

could impact upon the ability to trace into the balances in the LBIE house transaction accounts. This is best illustrated by a simple example.

73.1 A client pays LBIE £10 initial margin in respect of a futures contract which it enters into with LBIE. At the same time, LBIE enters into a back-to-back futures contract with a market counterparty which is duly novated and becomes a contract with the clearing house. On that particular day, LBIE is not required to provide margin to the clearing house in respect of the back-to-back contract because, on a net basis across all of its positions, there is already excess margin of £400 in the house transaction account. Accordingly, the client's £10 payment of initial margin was not used to provide the initial margin on the back-to-back futures contract in question.

73.2 When the back-to-back futures contract is closed out on LBIE's default, the sum paid by the clearing house to LBIE is a net amount calculated by reference to all of LBIE's positions with the clearing house in the LBIE house transaction account. If the back-to-back futures contract is closed out, in the money by £100, but LBIE's other positions are closed out, out of the money in the aggregate sum of £500, LBIE owes a net amount of £400 to the clearing house. As such, LBIE receives nothing from the clearing house (as the £400 owed by LBIE is taken from the £400 of margin held at the clearing house), even though the back-to-back futures contract relating to the client closed out in the money. Even if there is a net payment by the clearing house to LBIE after the closing of positions (because, for example, the balance on the house transaction account exceeds the amount owed by LBIE to the clearing house), it is not clear that the sum received by LBIE can be attributed to the client as a result of the netting of positions that has taken place. In summary, it is not clear if the client has any property rights in any part of the sums received from the clearing house (or if he has, in what amount), despite his individual position being in the money.

74 Accordingly, the Administrators seek directions as to whether it is possible to trace into the balances held in the LBIE house transaction accounts¹³. The Administrators have framed the directions to deal separately with the situation where (i) LBIE paid

¹³ For the avoidance of any doubt, the Administrators maintain that where money was segregated by LBIE in its client transaction accounts (as explained in paragraph 65 above) or in its core client money bank accounts, there will be no traceable client money in LBIE's house accounts (including LBIE's house transaction accounts). The client's property can no longer be held in a house account in circumstances where a corresponding amount of money was segregated for the client pre-Administration. The Administrators do not believe that this analysis is controversial or (it follows) that LBIE clients will attempt to bring claims of the type described. However, the Administrators will, of course, approach the Court for directions on this issue should it prove necessary to do so.

margin to the relevant clearing house or broker; and (ii) where such payments were made by an Affiliate on LBIE's behalf.

75 Where LBHI or another Affiliate paid margin to a clearing house or broker on behalf of LBIE, the points made in respect of the Debtor Settlements are equally relevant here. In this scenario, the Administrators do not believe that there will be sufficient evidential basis to support a tracing claim into LBIE's house transaction accounts. Moreover, the Administrators do not believe that LBIE or LBHI can be deemed to have appropriated these funds such that the balances in LBIE's house transaction accounts fall to be treated as client money. I consider this issue in more detail in paragraph 82 below.

76 Notwithstanding the above, if the balances on LBIE's house transaction accounts might otherwise be considered to be the proceeds of client money (or fall to be treated as such), the Administrators believe that there are certain factors which need to be considered and which may mean that there is in fact no traceable client money. These factors are set out at paragraph 14 of the Notice. Further background information will be provided in due course but, for the purposes of this statement, I make the following observations:

76.1 LBIE did not generally segregate any money for any transactions, including ETDs, carried out in respect of positions attributed to Affiliates. LBIE did segregate some money relating to futures and options trading undertaken on behalf of LBI for its underlying clients. The Administrators contend that (including in respect of LBI) LBIE believed that it did not have to treat money held for Affiliates as client money and that the Affiliates dealt with LBIE on that basis.

76.2 With limited exceptions¹⁴ the Affiliates did not fund ETDs attributed to their account. Requirements for initial margin and variation margin were generated by LBIE's systems, but no payment was received from the Affiliate. As noted, the position as between LBIE and its Affiliates in this respect was dealt with as part of the Lehman Group accounting procedures.

Other assets

77 As well as the payments made by LBHI in connection with OTC transactions and ETDs, LBHI may have made other payments, including payments entirely

¹⁴ For example, LBI provided cash margin in respect of a number of LBIE/LBI intercompany exchange-traded margined derivative accounts.

unconnected with LBIE's business, using money received from LBIE clients. Without access to LBHI's books and records, it is not possible for the Administrators to identify what other payments LBHI made and what (if any) value LBHI acquired in return for those payments. Similarly, the Administrators are unable to determine whether such payments utilised client money (or money that would have been client money under CASS if it had been received directly by LBIE).

- 78** It is also possible that LBIE may have made payments other than those identified above. The question at paragraph 12 of the Notice seeks to ascertain in what circumstances clients can trace value into the hands of third parties and whether there is scope for appropriation to be deemed to have taken place when LBHI or LBIE made payments to third parties. This direction is sought for the avoidance of doubt. Briggs J addressed the question of appropriation at paragraphs 187-188 of his judgment and made it clear that an actual, rather than a deemed, appropriation is required.

Consequential directions

- 79** The question at paragraph 13 of the Notice asks how, if client money can be identified, the client's claim is to be quantified in certain scenarios. I deal with each scenario below.

79.1 At paragraph 13(a) of the Notice, the Administrators seek guidance as to how to calculate a claim where the value represented by identifiable client money is only part of the total value supplied to the counterparty to an OTC transaction. For example, it is possible that a mixture of house money and client money was used to discharge a debt owed by LBIE to a swap counterparty. A swap is likely to involve a number of payments during its lifetime. A simple example would involve 10 payments of £10 to the counterparty over the life of the swap. LBIE made one payment of £10 with client money and 9 payments totalling £90 with its own funds. The swap was "in the money" at the time of Administration and when subsequently terminated. The question therefore arises as to whether and, if so, what proportion of the settlement received by LBIE following the close out of the swap transaction is the client's property.

79.2 The Administrators also seek guidance in respect of how best to value a claim arising out of the complex allocation issues relating to positions on

LBIE's house transaction accounts. This is discussed at paragraph 73 above.

Applicable Law

80 It is conceivable that assets which represent the traceable proceeds of client money are now located outside the jurisdiction. In relation to such assets, conflicts of law issues may arise. In circumstances where the relevant assets are now offshore, the question at paragraph 15 of the Notice seeks to establish which system of law governs whether the property is traceable and/or whether the current holder of the assets has a defence to a recovery action. If the Court directs that English law is the applicable law, it may be necessary to seek further directions from the Court, to establish whether money (or the proceeds of money) is identifiable in the hands of LBHI and whether LBHI has any defence to a claim to recover such identifiable money or its proceeds.

Credits pursuant to the LMP

81 The question at paragraph 16 of the Notice has been included to deal with certain arguments raised by LBI in submissions during the Client Money Application. The operation of the LMP is discussed in more detail in the section of this statement dealing with the factual background below. For the purpose of the question posed, the key point is that LBIE transferred money (possibly including money received from or for clients) to LBHI as part of the LMP. When LBIE calculated how much money needed to be segregated in order to meet its client money segregation obligations, LBHI funded LBIE to the extent that additional funding was required in order to meet those obligations. The question is aimed at determining whether funds received from LBHI which were not segregated or appropriated in some other way can nonetheless be treated as identifiable client money.

82 In the Client Money Application, LBI argued that LBIE ought to be assumed to be replenishing trust funds it had wrongly appropriated wherever it had spare cash. If LBI is correct in this regard, it presumably means that any money received by LBIE from LBHI (irrespective of whether it was in fact client money) should be treated as client money for tracing purposes. I am advised by Linklaters that, as a matter of law, for funds received by LBIE out of its other resources (such as payments from LBHI) to constitute client money, it is necessary to show that the relevant funds were expressly intended to be a substitute for client money which had been wrongly used. Such an intention would most likely be evidenced by segregating the relevant

funds. LBI's submissions in this regard were considered and rejected by Briggs J during the Client Money Application (see paragraphs 187 and 188 of his judgment). Nevertheless, LBI may wish to press this argument. The Administrators therefore seek an answer to the question for completeness.

Assumptions

83 To progress matters, the Administrators have had to make certain assumptions, such as whether certain accounts are likely to have contained client money. The Administrators intend to explain the approach they have adopted in due course, identifying the assumptions which have been made so that the Court may determine whether they have adopted a reasonable basis for identifying client money (if any) in LBIE's hands.

E. THE FACTUAL BACKGROUND

84 I set out below a brief summary of the factual background which is intended to inform the analysis of the legal issues raised in the directions sought by the Administrators.

The Administrators' investigations into the LMP

85 The matters discussed in this section have been learned as a result of the work carried out to date by the Administrators to determine how cash was managed within the Lehman Group and in particular how LBIE managed its cash. This work is ongoing, and the facts and observations set out in this section are necessarily of a preliminary nature and subject to change.

86 The Administrators' investigations into the factual background to the issues raised in this Application have focused on three key lines of inquiry to date:

86.1 a review of LBIE's internal documentation to identify documents explaining the purpose of the LMP and LBIE's cash management processes (the "document review");

86.2 discussions with key Lehman Group personnel formerly involved in managing the LMP and LBIE's accounts on a daily basis; and

86.3 the payment flow analysis.

The document review and discussions with former personnel of the Lehman Administration Companies

- 87 The document review has sought to identify relevant internal documentation explaining the LMP and cash management of LBIE's accounts. The review to date has focused primarily on the soft-copy documents held on the former Lehman Group servers in London, which comprises approximately 27 million documents¹⁵. The document review team has conducted searches across these archives to identify potentially relevant documents. To date, approximately 10,000 documents have been identified as potentially relevant of which some 9,000 have been reviewed to date. This review process is ongoing.
- 88 Based on the document review to date, it appears that LBIE's cash management process was not documented in a readily available format. The Administrators and their advisors have also met with former personnel of the Lehman Administration Companies involved in managing the LMP and LBIE's bank accounts to further inform the factual background to the Application. These discussions (together with the payment flow analysis) are intended to corroborate and supplement the information gathered as part of the document review.
- 89 As a result of the document review and the discussions with former personnel of the Lehman Administration Companies, my team has formed a preliminary view of LBIE's cash management process. I set out below some brief observations regarding (i) the funding framework; and (ii) LBIE's bank accounts based on the investigations completed to date.

The Lehman Group – the funding framework and LMP¹⁶

- 90 The principal aims of the Treasury department were to:
- 90.1 fund all business needs;
 - 90.2 keep the Lehman Group safe from a liquidity standpoint; and
 - 90.3 ensure effective use of the Lehman Group's capital.
- 91 In order to achieve these aims, the Lehman Group operated a funding framework and cash management model which promoted the holding of excess cash in LBHI as far as possible and the maintenance of a liquidity pool adequate to cover all expected cash outflows over a 12 month period in a stressed environment.

¹⁵ The number of documents is based on a listing of documents on the servers taken in June 2010.

¹⁶ I have explained in detail in the context of the Client Money Application how LBIE sought to comply with the requirements of CASS and specifically how LBIE's funding requirements to meet its client money segregation obligation under CASS was managed. I do not propose to consider these issues here.

- 92 LBHI was the ultimate parent company within the Lehman Group and acted as the central “banker”. This meant that, in general, any excess cash belonging to a given subsidiary (i.e. cash not required to be held in a bank account in the name of the subsidiary, for example, to fund that day’s settlement activity or for regulatory reasons) was held in a bank account in the name of LBHI, either LBHI NY or LBHI UK). The fact that the cash actually “belonged” to the subsidiary was recorded by way of intercompany accounting entries. In addition, LBHI provided extra funding to its subsidiaries where required¹⁷ and, in the case of LBIE at least, loaned LBIE funds for investment, in order to maintain the requisite receivable balance due from LBIE (as explained in paragraph 46 above).
- 93 As a result, there was a constant flow of funds between LBHI and its subsidiaries. Where there were excess funds in an entity’s accounts towards the end of each trading day, those funds were generally transferred up to LBHI NY (in LBIE’s case via LBHI UK) for investment overnight as part of the LMP, to the extent practicable. Conversely, where an entity required extra funding on a given day, those funds were transferred down from LBHI to the entity concerned.

LBIE’s bank accounts

- 94 The Lehman Group (including LBIE) sought to minimise the number of bank accounts it held, for practical and commercial reasons which included minimising fees relating to account maintenance and cash transfers. However, there were limits to the extent to which this could be achieved. For example, LBIE was required to hold separate “real world” bank accounts in each external market in which it operated. Within each external market, separate bank accounts could also be required for each different currency in which it transacted. Depending on the market, separate bank accounts were required for different types of activity (for example, in some markets for operational processing and efficiency reasons, LBIE held separate bank accounts for trade settlements and dividend receipt purposes).
- 95 As a result, LBIE’s network of external bank accounts was extensive. However, I am advised by former employees of the Lehman Administration Companies that the Lehman Group Treasury function closely controlled the opening of new bank accounts, such that new bank accounts were only opened if it was not possible to use existing bank accounts to support the additional activity. Each LBIE bank account was therefore opened for a specific purpose and would have been

¹⁷ LBHI would source extra liquidity, for example, through its own debt issuance, the issuance of debt by Lehman Brothers Treasury Company B.V. or through the Lehman Group’s banking entities.

supported by an appropriate business justification from the department requesting the new account.

The payment flow analysis

- 96** Employees from PwC and ex-employees of the Lehman Administration Companies (collectively, “**the payment flow team**”) have been analysing LBIE’s records as part of what I (as noted above) term the “payment flow analysis”.
- 97** The payment flow analysis is a forensic review of the activity in LBIE’s bank accounts between 1 and 15 September 2008 which involves (among other things): (i) identifying cash receipts into those accounts and classifying accounts based on the risk that client money was paid into them; (ii) tracking payments made from those accounts (including transfers between LBIE bank accounts); and (iii) conducting a high level review of the receipts and payments to and from those accounts to determine whether specific cash payments into those accounts could be readily identified as having been transferred out of those accounts.
- 98** The payment flow analysis serves two purposes: (i) to aid the Administrators’ understanding of the LMP; and (ii) to identify client money (if any) in LBIE’s house accounts.

The payment flow analysis – the LMP

- 99** In the context of the Administrators’ investigations into the LMP it should provide the Administrators with a detailed view of cash flows: (i) between LBIE and LBHI accounts; (ii) between different LBIE accounts; and (iii) between LBIE and other Affiliate accounts. This can be used to inform the Administrators’ understanding of the LMP and, in particular, ascertain whether the transfers observed during the review period bear out the understanding obtained from the document review and the discussions with former Lehman Group employees.
- 100** This investigative work is ongoing so any conclusions reached at this stage are necessarily tentative. Nonetheless, the payment flow team’s preliminary investigation supports the view that LBIE used specific bank accounts for specific purposes and specific currencies. Our detailed findings will be set out in future witness statements, once this work has been completed. A short summary of our findings to date is set out below.
- 101** A total of approximately 390,000 transactions (i.e. payments into and payments out of LBIE’s house accounts) in the review period have been analysed. Those

transactions relate primarily to trade settlement and asset servicing/custodian transactions. We currently estimate that less than 1% (by number) of these transactions were **treasury transfers** (i.e. a transfer from a LBIE house account to another LBIE house account or between a LBIE house account and an LBHI UK account or other Affiliate account).

- 102** The significant majority of the treasury transfers were movements of cash between a LBIE house account and an LBHI UK account. This is consistent with our general understanding of the LMP, which is that if there was a funding shortfall in one of LBIE's accounts, generally speaking that shortfall would be met by LBHI UK transferring funds directly into that account. However, the payment flow analysis has revealed that in certain limited instances LBIE would fund the shortfall directly by transferring funds from another LBIE house account.

The payment flow analysis – identifying client money in LBIE's accounts

- 103** As referred to above, the payment flow analysis is also relevant from an identification perspective, and, in this respect, has two objectives:

- 103.1** establishing what (if any) client money is held by LBIE and identifying client money (or its substitute) to be added to the CMP or returned to individual clients (as the case may be) (a **"trust asset"**); and
- 103.2** identifying what is a LBIE asset to be used ultimately to fund distributions to unsecured creditors (a **"house asset"**).

In short, for this purpose, the payment flow analysis is directed at determining whether any particular asset held by LBIE is a trust asset or a house asset.

- 104** Transactions that occurred during the review period were reviewed and categorised according to the activity to which they related and subsequently classified as client or house related. As a result of analysing accounts and classifying transactions and parties to the transactions, accounts were categorised as "high", "medium" or "low" risk, based on the prospect that the account was one into which client money was received. The "low risk" designation was reserved for accounts where the receipts reviewed related solely to house activity. To date, 224 high or medium risk accounts have been identified. Client related receipts into a high or medium risk account that was in credit at the close of business on 12 September 2008 (and which were received into the account during the 2 week review period) have been reviewed.

105 There are further verification steps to be completed but, as at the date of this statement, the payment flow team has identified a pool of potentially client related receipts that may ultimately be client money. Of course, the fact that a receipt is client related does not make it client money. It is still necessary to:

105.1 complete a legal analysis of whether receipts are client money;

105.2 determine if the receipts remain in the account or have been paid away (for example, if the client was repaid by LBIE or if an equivalent amount of money was segregated by LBIE); and

105.3 if money has been paid away, determining where it has gone (or what it has been converted into) and completing a further analysis of whether paid-away/converted money can be recovered.

106 Until the above analysis has been completed, the Administrators will not be in a position to reach any firm conclusions as to the likelihood or otherwise of client money being found in LBIE's house accounts. The analysis is likely to take a number of months to complete.

F. TIMETABLE AND OTHER PROCEDURAL MATTERS

107 The Court is not invited, on the first return date, to appoint respondents or to set a procedural timetable.

108 As to prospective respondents, the Administrators have held discussions with various client money claimants to establish whether or not those parties would be willing to be joined as a respondent to the Application. Potential respondents have asked for time to consider the content of the Notice and this statement before reaching a decision. As things stand, the Administrators believe that it will be necessary for a LBIE client to be appointed as a representative respondent to represent those clients who have an interest in arguing (amongst other things) that LBIE's bank accounts and other house assets should be aggregated for tracing purposes. The Administrators also anticipate that certain Affiliates will also want to be appointed as a respondent. The Administrators will continue discussions with the various interested parties and will keep the Court updated as to progress.

109 As to further evidence, and as I have explained above, the Administrators continue to progress their factual investigations and will produce further evidence in accordance with a Court sanctioned timetable which will need to be agreed in due

course. As matters currently stand, it is anticipated that additional witness evidence will be required in respect of:

109.1 the LMP;

109.2 the payment flow analysis;

109.3 Debtor Settlements; and

109.4 LBIE's house transaction accounts.

110 Once the Administrators' further evidence has been filed, they believe that it would be appropriate to have a further procedural hearing during which the Court should be in a position formally to appoint the respondents to the Application and make further procedural directions to establish how and when the substantive issues raised by the Application will be determined.

111 In these circumstances, the Court is invited to fix a further procedural directions hearing on the first available date in the Michaelmas Term at which to consider the appointment of respondents and the setting of a timetable for the substantive determination of the Application. By such time it is envisaged that the Administrators will have filed their further evidence and the prospective respondents will have had opportunity to consider that evidence.

112 In the meantime, the Court is invited to make a costs order in accordance with paragraph 18 of the Notice.

STATEMENT OF TRUTH

I believe that the facts stated in this witness statement are true.

Signed: 

ANDREW PETER CLARK

8 April 2011

Applicants
A P Clark
Seventh Statement
"APC7"
8 April 2011

IN THE HIGH COURT OF JUSTICE

No. 7942 of 2008

CHANCERY DIVISION

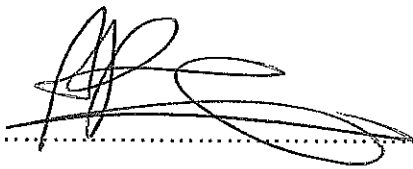
COMPANIES COURT

**IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in
administration)**

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

EXHIBIT APC7

This is the paginated bundle of copy documents marked "APC7" referred to in the witness statement of ANDREW PETER CLARK dated this 8th day of April 2011.

Signed: 

ANDREW PETER CLARK

8 April 2011

IN THE HIGH COURT OF JUSTICE

No. 7942 of 2008

CHANCERY DIVISION

COMPANIES COURT

In the matter of Lehman Brothers International (Europe) (in administration)

And in the matter of the Insolvency Act 1986

ORDINARY APPLICATION

**Linklaters LLP (Satindar Dogra/Stephen Fletcher)
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Fax: (44-20) 7456 2222
Solicitors for the Applicants**

IN THE HIGH COURT OF JUSTICE

No. 7942 of 2008

CHANCERY DIVISION

COMPANIES COURT

In the matter of Lehman Brothers International (Europe) (in administration)

And in the matter of the Insolvency Act 1986

ORDINARY APPLICATION

TAKE NOTICE that Steven Anthony Pearson, Anthony Victor Lomas, Michael John Andrew Jervis, Dan Yoram Schwarzmann and Derek Anthony Howell of PricewaterhouseCoopers LLP, Plumtree Court, London EC4A 4HT ("**Joint Administrators**"), the Joint Administrators of Lehman Brothers International (Europe) ("**LBIE**"), intend to apply to the Judge on:

Date:

Time:

Place: Court 59, Royal Courts of Justice, Strand, London

For directions pursuant to paragraph 63 of Schedule B1 to the Insolvency Act 1986 and for orders as follows.

General principles

- 1 Where LBIE received or held client money on trust for a client¹ which was credited to a house account:-
 - (a) is that client money or any traceable proceeds to be identified by reference to that house account alone or by reference to an aggregate of accounts and, if so, which?

¹ A term used to mean any entity or person who dealt with LBIE and who may be entitled to assert that LBIE received client money on its behalf (including any other company that formed part of the Lehman Group).

- (b) in order to identify that client money or any traceable proceeds, which of the following evidential presumptions should be applied, and how?
- (i) The "first in, first out" basis, as in Clayton's Case [1814-23] All ER Rep 1.
 - (ii) Pari passu, as, for example, in Barlow Clowes International Limited v Vaughan [1992] 4 All ER 22.
 - (iii) The rules in Re Hallett (1880) 13 Ch D 696 and Re Oatway [1903] 2 Ch 35: initial withdrawals from a mixed account are deemed to be made with the trustee's own funds, unless those withdrawals have resulted in a lucrative investment which the client wishes to claim.
 - (iv) The lowest intermediate balance principle enunciated in Roscoe (Bolton) v Winder [1915] 1 Ch 62, and, if so, should the principle be applied by reference to closing (rather than intra-day) balances?
 - (v) Some other presumption and, if so, what?

- 2 How should the identification analysis be conducted in relation to an account in circumstances where it has not been possible to establish, in respect of the period of 2 weeks ending with the commencement of LBIE's administration, the extent to which the sums standing to the credit of the account during that period comprise client and house money respectively?

Bar date

- 3 Any client who maintains that client money was paid to LBIE:-
- (a) prior to 1 September 2008; or
 - (b) in the period 1 September to 07.56 on 15 September 2008 and which has not been acknowledged by the Joint Administrators in writing;

in respect of which the client has received no value shall communicate, by a date to be directed by the Court (the "**Bar Date**") and by a specified manner, the following information to the Joint Administrators, namely, (a) the date on which the payment was made, (b) the amount of the payment and (c) the reason for the payment (including identifying and providing a copy of any contract pursuant to which the payment was made).

- 4 The Joint Administrators shall give such notice as the Court shall direct of the Bar Date by:
- (a) placing an announcement on the Lehman section of the PricewaterhouseCoopers LLP website (http://www.pwc.co.uk/eng/issues/lehman_updates.html) (the "Notice");
 - (b) publishing the Notice in the Financial Times and the Wall Street Journal.
- 5 If, after the Bar Date has passed, the Joint Administrators procure that LBIE does, and LBIE does:
- 5.1 distribute client money to clients who, on the basis of information available to LBIE and the Joint Administrators at the time of such distribution, are entitled to it; and
 - 5.2 appropriate or distribute such money or assets as, on the basis of the information available to LBIE and the Administrators at the time of such appropriation, legally and beneficially belong to LBIE;

LBIE and the Administrators will not be liable in respect of any breach of trust (whether as trustee or accessory) to any client seeking to maintain a proprietary claim to client money in respect of any additional claims not reflected by the distributions and/or appropriations actually made where, prior to the distributions and/or appropriations being made, LBIE and the Administrators did not have information available to them to support the existence of those additional proprietary claims.

Payments of client money direct to Affiliates

- 6 When clients, at the direction of LBIE, paid money to an Affiliate (which money would have been client money under CASS if received directly by LBIE), did the receipt of money by the Affiliate result in there being client money or some other asset in LBIE's hands, into which money or other asset (or the identifiable proceeds of which) a client might trace value?
- 7 Does the answer to question 6 change in the event that the payment was made at a time when LBIE was a net debtor of the Affiliate?
- 8 What is the scope of the Joint Administrators' duty (if any):-
- (a) in relation to establishing whether any payments made by the Affiliate were payments of client money?

- (b) in relation to vindication of clients' proprietary rights (if any) against the Affiliate or any person to whom that Affiliate paid money?

Identifying specific proceeds

- 9 In what circumstances are payments received or to be received by LBIE in settlement of debts owed by counterparties of LBIE pursuant to "over the counter" and other off-exchange transactions entered into with LBIE prior to its entry into administration the proceeds (or to be treated as the proceeds) of identifiable client money?
- 10 Does the answer to question 9 above turn upon whether value was provided to the counterparty, by whom and in what form?
- 11 In what circumstances are sums standing to the credit of transaction accounts other than client transaction accounts and payments received or to be received by LBIE from clearing houses and intermediate brokers in connection with on exchange transactions executed by LBIE prior to its entry into administration the proceeds (or to be treated as the proceeds) of identifiable client money in circumstances where margin in respect of the relevant transaction was provided on a net basis:
 - (i) by LBIE;
 - (ii) by an Affiliate on behalf of LBIE.
- 12 In what circumstances can value be traced by clients from any identifiable money received by an Affiliate (which money would have been client money under CASS if received directly by LBIE) into the hands of third parties to whom the Affiliate paid money other than as addressed in the answers to issues 9, 10 and 11 above?
- 13 If the answer to questions 9, 10, 11 or 12 is that value can be followed in these circumstances, how is the client's proprietary claim to be quantified in circumstances where:-
 - (a) the value provided by or on behalf of LBIE was only part of the total value provided pursuant to the contract?
 - (b) the closing balance on the house transaction account (and the amount returned or to be returned to LBIE) was the product of (i) margin provided by or on behalf of LBIE on a net basis for all positions on the account and (ii) the proceeds of closed-out transactions, including transactions referable to the client (the "**Client Positions**"), but (x) no part of that balance (including

margin paid) was identified by LBIE or the relevant clearing house or intermediate broker as being specifically referable to the Client Positions, and (y) transactions were closed out at prices and in a manner beyond LBIE's control?

- 14 To what extent, if at all, is the answer to question 13 affected by the following factors:-
- (a) an agreement, assumption or understanding that money would not be segregated by LBIE for a particular client (for a reason other than a total title transfer arrangement)?
 - (b) LBIE not calling for payment of margin from a particular client?

Applicable law

- 15 When assets into which clients may wish to attempt to trace value are situated outside England, which law governs whether the property is traceable and/or whether the current holder of the assets has a defence to a recovery action?

Credits pursuant to the Liquidity Management Process ("LMP")

- 16 In what circumstances should payments made by LBHI to LBIE as part of the LMP be treated as the proceeds of identifiable client money? Specifically, is appropriation a necessary requisite? If so, in what, if any, circumstances, should appropriation be deemed to have occurred?

Assumptions

- 17 What assumptions are the Joint Administrators entitled to make in their analysis of whether particular sums of client money or the proceeds of those sums remain identifiable?

Case management orders

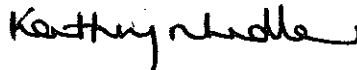
- 18 The Administrators' costs, fees and expenses of and occasioned by this application be paid:
- (a) as an expense of the administration; or
 - (b) from client money subject of the statutory trust; or
 - (c) in part as an expense of the administration and in part from client money subject of the statutory trust;

in such proportions as shall be ordered by the Court, and/or that such other order may be made as to the incidence of the Administrators' costs, fees and expenses of this application as the Court thinks fit.

19 Such further order or relief as the Court thinks fit.

Dated this 8th day of April 2011

Signed:


Partner

Solicitors for the Applicant:

Linklaters LLP

Address for service:

Linklaters LLP

One Silk Street

London

EC2Y 8HQ

Ref: Satindar Dogra/Stephen Fletcher

Notice of this Application has been given to the Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS

It is not intended to serve any person with this Application.

If you do not attend, the Court will make such order as it thinks fit