

21 November 2012

## Clearing Houses Joined as Parties in MF Global Dispute at the High Court in London

**Three European clearing houses applied to be joined as parties to proceedings concerning the ownership of certain US Treasury bills brought by the administrators of MF Global UK Ltd against MF Global Inc (acting through its bankruptcy trustee). MF Global Inc claimed ownership over these T-Bills, which had been transferred to the European arm of the MF Global group allegedly on a title transfer basis to secure MF Global Inc's customer positions. Some of these T-bills were then posted as collateral at European clearing houses by MF Global UK Ltd. The court held that the three applicant clearing houses were entitled to be joined to the proceedings, as they had a direct interest in the outcome.**

### Background

MF Global was an international brokerage group trading derivatives and other financial instruments both for its own account and for customers. One of the reasons that the group became insolvent was because of losses suffered on proprietary trades in Euro government bonds. MF Global, Inc (“**MFG Inc**”) was the main US trading entity, acting as a broker dealer for its US and international clients. MF Global UK Ltd (“**MFG UK**”) handled the European business of the group. On 31 October 2011, MFG Inc filed for Chapter 11 bankruptcy protection in the US and subsequently entered a liquidation process governed by the US Securities Investor Protection Act 1970. MFG UK entered special administration under the Investment Bank Special Administration Regulations 2011 (in the UK) on the same date.

Before the collapse of the MF Global group, MFG UK entered into trades with MFG Inc which related in turn to transactions brokered by MFG Inc for its clients. The trades were made through MFG UK because they were cleared on European clearing houses of which MFG UK was a member. In order to cover the collateral required for this trading activity, MFG Inc transferred T-Bills (among other assets) to MFG UK, with a total value of approximately \$640 million, which MFG UK alleges were provided on a title transfer basis. Some of the T-Bills were then further transferred as collateral by MFG UK to various European clearing houses.

Subsequent to the collapse of the MF Global group, MFG Inc's bankruptcy trustee demanded the return of the T-Bills on the basis that they represented client assets or were subject to some other trust interest as a result of US customer segregation rules or otherwise. MFG UK's administrators filed proceedings in the English courts in May 2012 for directions as to which of MFG UK or MFG Inc owns the T-Bills and as to how the proceeds following liquidation of the T-Bills should be distributed to creditors. MFG Inc claimed ownership of the T-Bills as against MFG UK and, further, put MFG UK to proof on its claim of having transferred the T-Bills to clearing houses. Finally, MFG Inc reserved its rights to claim for the full amount of T-Bills posted as collateral at the clearing houses.

LCH.Clearnet Ltd, LCH.Clearnet SA and ICE Clear Europe Limited (the “**Clearing Houses**”) applied to be joined as parties to the proceedings between MFG UK and MFG Inc or to be permitted to intervene in the proceedings in order to make submissions to the court. MFG Inc’s position was that it was beneficially entitled to the T-Bills before the transfer of the T-Bills to the Clearing Houses, and, in addition, MFG Inc reserved its rights in relation to the question of whether the Clearing Houses were entitled to deal with the assets and acted in a manner inconsistent with MFG Inc’s rights. MFG UK and the Clearing Houses, on the other hand, accept or contend that MFG Inc’s claim (if any) is restricted to a claim in respect of part of a contractual receivable representing the net balance of the liquidated T-Bills minus any deducted amounts owed to the Clearing Houses, as calculated in accordance with Clearing Houses’ rules. The hearing of the Clearing Houses’ application took place at the High Court in London on 15 November 2012. The court’s judgment was handed down the following morning.

## The Decision

The court generally has discretion to add a new party to existing proceedings in cases where it is desirable to complete proceedings or if a third party is affected.<sup>1</sup> MFG Inc contested the Clearing Houses’ application to be joined on various grounds, including that the proceedings between MFG UK and MFG Inc would not, it was asserted, affect the Clearing Houses’ rights and that joining the Clearing Houses as parties would cause delays and increase costs. Mr Justice David Richards held that if MFG Inc succeeded, the case could fundamentally affect the Clearing Houses’ rights. A finding of ownership or other rights relating to the T-Bills in favour of MFG Inc would effectively be the first of two steps in a case against the Clearing Houses, which would (if MFG Inc were found to have ownership rights relating to the T-bills) turn only on whether the Clearing Houses had notice. Accordingly, the judge found that the Clearing Houses had a direct legal interest in the question being litigated and a strong basis upon which to be joined to the proceedings between MFG UK and MFG Inc as to which of those two parties had the better title. The judge considered that because of the real possibility of re-litigation and inconsistent decisions, the applicant Clearing Houses should be joined to the proceedings.

The judge also decided that mere intervention would not be appropriate. The Clearing Houses had suggested that, similar to recent interventions by the International Swaps and Derivatives Association on the ISDA master agreement or the Premier League on its regulations,<sup>2</sup> clearing houses could intervene to provide information to the court on the interpretation of their clearing rules. The public interest nature of clearing services provision and use of clearing houses to satisfy regulatory obligations were drawn to the judge’s attention. However, it was held that the Clearing Houses, in addition to being interested in intervening, also had a legal interest in the outcome of the litigation. The judge therefore wished to take a course of action that would ensure that the Clearing Houses not only could supply useful information to the court, but would also be bound by the court’s decision on ownership and related issues in respect of the T-Bills as between MFG UK and MFG Inc. The joinder is, however, strictly limited in scope to questions of which of MFG UK and MFG Inc was the beneficial owner of any interest in the relevant T-Bills, or any receivable or proceeds in respect thereof. This restriction in scope was intended to avoid the case being subject to more delays or dealing with additional novel issues.

<sup>1</sup> CPR, r. 19.2(2).

<sup>2</sup> See the intervention of ISDA in *Lomas v Firth Rixson* [2010] EWHC 3372 (Ch) and the intervention of the FA Premier League in *HMRC v Football League Ltd* [2012] EWHC 1372 (Ch).

## Conclusions

This decision is an example of how the use of “assumed facts” in an administration hearing, coupled with a standard “reservation of rights” in litigation can have perhaps unforeseen outcomes in the inter-connected world of financial markets. The interests of market infrastructure providers such as clearing houses cannot be ignored by the administrators or trustees of insolvent financial institutions where rights of the insolvent parties are litigated, but subject to third-party property interests.

The Clearing Houses, as a result of their successful joinder applications, will now be parties to the proceedings in which the ownership issues in relation to the T-Bills as between MFG UK and MFG US will be decided. The Clearing Houses will be entitled to submit evidence to the court where relevant and to present details of their rules and the legislation applicable to clearing houses to the extent that this is relevant to property rights or contractual entitlements as between MFG UK and MFG Inc.

In the recent Lehman client money case<sup>3</sup>, various questionable statements and assertions were made in some judgments about client transaction accounts at clearing houses, in the absence of clearing house rules or relevant legislation (such as Part VII of the Companies Act 1989 or the Settlement Finality Directive) being cited.<sup>4</sup> This seems less likely to be an outcome in the MF Global proceedings as a result of the joinder of the Clearing Houses.

This joinder case is likely to prove an important legal precedent for joinder and intervention applications, both in the context of UK administration proceedings and perhaps more generally.<sup>5</sup>

Shearman & Sterling acted for ICE Clear Europe Limited in these proceedings.

<sup>3</sup> *Re Lehman Brothers International (Europe)* [2009] EWHC 3228 (Ch); [2010] 2 BCLC 301.

<sup>4</sup> If you wish to review further information, please consult our client publication on this topic: “More Lessons from Lehman: Protecting Client Assets Held with UK-Incorporated Investment Banking Entities” at <http://www.shearman.com/more-lessons-from-lehman-protecting-client-assets-12-23-2009/>.

<sup>5</sup> A Lawtel case report is available at: <http://www.lawtel.com/MyLawtel/Documents/AC9401231>.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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