

"Trust claims and client monies: left high and dry or scooping the pool?"

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The problem

1. The position of the unsecured creditor in any insolvency process is ostensibly fair but extremely precarious. Pari passu distribution¹ shares out between all of the unsecured creditors all of the available assets (i.e. the assets that are not subject to any prior security interest) after payment of costs and expenses and after any preferential claims. The risks of non-recovery are considerable bearing in mind the constraints imposed by (a) shortfalls in assets due particularly to the claims of secured creditors and (b) the need to meet the costs of whatever insolvency process applies which will necessarily increase any asset shortfall.
2. The question thus arises of whether and to what extent it is possible to arrange matters to improve ones position in case a counterparty fails at a time when it is holding monies that have been paid over or received on behalf of a client or customer whether they represent any or all of a prepayment, a deposit, or a retention.

A possible solution

3. A possible solution is to attempt pre-empt the entire general pari passu distributive process by attempting so to structure ones business relationship with a counterparty that one has a direct interest in particular identifiable assets or monies of that counterparty as the beneficiary of a trust.

¹ See s.107 of the Insolvency Act 1986 (applicable to all voluntary windings up)

“Subject to the provisions of this Act as to preferential payments, the company’s property in a voluntary winding up shall on the winding up be applied in satisfaction of the company’s liabilities pari passu and, subject to that application, shall (unless the articles otherwise provide) be distributed among the members according to their rights and interests in the company”

and Insolvency Rule 4.181(1) (not applicable to creditors voluntary winding up)

“Debts other than preferential debts rank equally between themselves in the winding up and, after the preferential debts, shall be paid in full unless the assets are insufficient for meeting them, in which case they abate in equal proportions between themselves.”

(the equivalent provision in personal insolvency is s. 328(3) of the Insolvency Act 1986 which largely mirrors the provisions in Rule 4.181(1)).

4. If such a claim succeeds then the benefits can be considerable for the claimant provided always that the available “trust” assets are not exhausted by the extent of the trust claims. A particular benefit is that trust assets will not, or should not, be subject to claims either by secured creditors or for general insolvency costs but instead only to the costs or preservation or realisation. However, a risk remains that there will not be sufficient assets to fully satisfy all trust claims.

When will a trust claim be available ?

5. The simple answer is when there is a completely constituted trust. When there is not simply a relationship of debtor and creditor but instead a relationship of trustee and beneficiary.
6. This simple answer reveals a vital; point. It is necessary that a trust has actually been created. This can be a properly declared private trust (whether under terms of the contract with the counterparty, or even if declared unilaterally by the counterparty), or it can be a constructive or resulting trust (e.g. *Barclays Bank v Quistclose [1970] AC 567*). A further possibility is the statutory trust which now arises in the Regulated Sector subject to MFID under Chapter 7 of the Client Assets sourcebook (CASS) (<http://fsahandbook.info/FSA/html/handbook/CASS>).
7. The nature of the scheme under Chapter 7 of CASS should be noted and is helpfully summarised in two of the opening paragraphs of Briggs J’s monumental judgment in the *Lehman Brothers*² case.

“2. When first read, CASS7 appears to provide a relatively straightforward and intelligible code for the safeguarding of client money by regulated firms. In the barest outline, it provides for client money to be identified and promptly paid into segregated accounts, segregated that is from the firm’s house accounts. It provides for client money to be held on trust, in substance for the clients for whom it is received and held. Finally in the event of the failure of the firm, the rules provide for the pooling of the client money, thus far segregated and held on trust, and for its distribution to those entitled to it under that trust, pari passu in the event of a shortfall.

3. In an ideal world, the flawless operation of the scheme created by the CASS7 rules would ensure first, that the clients’ money could not be used by the firm for its own account and secondly, that upon the firm’s insolvency, the clients would receive back their money in full, (subject only to the proper costs of its distribution) free from the claims of the firm’s creditors under the statutory insolvency scheme. The rules would achieve those twin objectives by ensuring that, promptly upon receipt, client money was held by a firm as trustee, separately

² *Lehman Brothers International (Europe) (In Administration) v CRC Credit Fund Limited & Ors [2009] EWHC 3228 (Ch)*² (Briggs J.) As yet not fully reported – presumably due to its great length (125 pages of transcript). The transcript can be found at <http://www.bailii.org/ew/cases/EWHC/Ch/2009/3228.html> and a useful brief summary/headnote is available on Lawtel/Westlaw.

and distinctly from the firm's own money and other assets, and therefore out of the reach both of the firm (for the conduct of its business) and of the firm's administrator or liquidator upon its insolvency (for distribution among its creditors)."

8. The CASS scheme is in concept a good one, but as ever the devil is in the detail which can be appreciated by reading the 40 or so pages of the chapter. However the real complexities of the scheme are fully exposed in the next 426 paragraphs of the judgment in the *Lehman* case. The immediate point to note is that it certainly does not guarantee that client monies are fully secured: indeed the statutory trust under Chapter 7 of CASS imposes its own pari passu distribution rules as between the claimants under the statutory trust.
9. Many attempts to establish a trust will and do fall at the initial hurdle – was a trust declared, and if so, has it been completed by setting aside the necessary funds?
10. It is important to bear in mind that just because someone pays or deposits money with a counterparty that does not of itself mean that a trust is created. In many cases such a relationship will be purely contractual – e.g. the relationship of banker and customer or supplier and customer. This is what the unfortunate customers of The Fees Company³ discovered in the autumn of last year.
11. Similarly in the case of payments to agents – a pre-payment to ones own agent may well be held on trust if that is what the agency contract provides, but a payment to a counterparty's agent is highly unlikely to be. That is what most of the unfortunate customers of Farepak⁴ discovered in the autumn of 2006.
12. The Farepak insolvency is instructive for a number of reasons. In the case of Farepak a very few of the customers who made payments to Farepak's agents after an express trust had been defectively declared by Farepack were ultimately successful in making

³ The Fees Company Limited, a Scottish registered company which traded throughout the UK, operated a credit scheme for parents and members, and a BACS fee collection scheme for private schools and golf clubs under which school fees and membership fees were collected from customers on a monthly or other regular basis (collected partly in advance and partly in arrears together with administrative and finance charges) and payments then made to the school or club on a termly or other periodic basis. This company failed at a time when it had collected instalments in advance from parents and members but had not yet paid them over to the schools and clubs. The relationship between the Company and its customers was entirely contractual.

⁴ Farepak Limited operated a Christmas savings scheme under which customers made regular payments to agents of the Company throughout the year and in return were supplied with gift vouchers, hampers or goods at the end of the year. It ceased trading in October 2006 just before it would have been obliged to meet its obligations to its customers. The anticipated dividend for unsecured creditors including some 120,000 customers is likely to be in the region of 5 p in the £ on claims that are mostly for less than £ 200.

a trust claim in respect of those sums – see *Re Farepak Food and Gifts Ltd (In Liquidation) Power v Revenue and Customs Commissioners* [2009] EWHC 2580 (Ch), [2010] 1 BCC 444 (Warren J.), but all the other trust claims failed.

13. In particular attempts claims made on the basis of a resulting or constructive trust to payments that were received in Farepak’s bank account after it had decided to cease trading failed because it was found that once payment was made to one of Farepak’s agents the relationship of the parties was a purely contractual one of debtor and creditor; and it was not unconscionable or contrary to the Rule in *Ex P. James (1874) LR 9 Ch App 609* for Farepak and its Administrators to rely upon their legal rights in the monies that had been so received – see *Re Farepak Food and Gifts Limited (In Administration)* [2006] EWHC 3272 (Ch), [2007] 2 BCLC 1 (Mann J.)

Trust Claims are not a Universal Panacea:

14. It is instructive to note the extremely limited benefit that was received from even the successful trust claims in the *Farepak* case. In late 2009, 3 years after the onset of insolvency and only after considerable costs had been incurred, some £ 243,000 was paid to some 5,000 customers in settlement of trust claims.
15. It should also be noted that it is not sufficient that the parties have agreed as a matter of contract, or even that they are bound as a matter of statutory regulation, to establish a trust if the trust has not in fact been completely constituted. If the “trustee” breaches its contractual obligation to establish the trust then any trust claim will fail to the extent of this breach. This applies both to ordinary private trusts – see *Mac-Jordan Construction Limited v Brookmount Erostin Limited (In Receivership)* [1992] BCLC 350 (CA) – and also to the Statutory trusts that arise under Chapter 7 of CASS – see *Re Global Trader Europe (In Liquidation)* [2009] EWHC 602 (Ch), [2009] 2 BCLC 18 (Sir Andrew Park) and the *Lehman* case.
16. It is not possible to argue that because there was an obligation to establish a trust any available assets should even after insolvency has occurred be set aside and impressed with the trust. This is a possible argument prior to insolvency, but once insolvency has occurred or is imminent or even possible this argument cannot possibly succeed because the creation of a trust in such circumstances would almost certainly constitute an unlawful preference as it would put the beneficiary under the trust in a better position than the creditors generally – see again *MacJordan* as approved in both *Global Trader* and *Lehman*.
17. Even if a trust has been declared (and properly declared – see *Farepak* again) a trust claim will only succeed to the extent that there are assets available to meet the claim. For an extreme demonstration of this principle in action see again the *Lehman* case.

18. Both the *Global Trader* and the *Lehman* cases well demonstrate that the Chapter 7 CASS provisions while useful are not a complete remedy for those who can, or perhaps more important should be able to, bring themselves within their ambit.

Conclusion:

19. It is possible by careful drafting⁵ in advance of insolvency, and prior to committing ones funds, to improve ones position in case insolvency does later supervene by requiring that ones monies are held on trust by a counterparty. If this is done there are greater chances that one will be able to have first call, or at least a shared right of first call, on particular assets of the counterparty. However, nothing can ever fully guard against the effects of accident, negligence, or fraud by a counterparty, and there always remains the possibility that even a trust claim will prove valueless.

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⁵ There are always limits to clever drafting. In a slightly different but nevertheless relevant Insolvency context consider the recent amendments to the Insolvency Act 1986 and Insolvency Rules 1986 under The Legislative Reform (Insolvency) (Miscellaneous Provisions) Order 2010 No. 18, The Insolvency (Amendment) Rules 2010 No. 686, and more particularly The Insolvency (Amendment) (No. 2) Rules 2010 No 734 which 7 days after their publication corrected a number of glaring errors in the Rules at No 686. One of the amendments in particular stands out because of the explanatory note in which the draughtsman when telling us what he had been hoping to achieve with is drafting says with disarming frankness:- "*Rule 9 removes paragraph 538 from Schedule 1 to the Insolvency (Amendment) Rules 2010. (It does not make sense and was included in error.)*"