

Sector Focus

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The insolvency of financial services firms

KEY POINTS

- The failure of a financial services firm can engage a series of bespoke rules which modify or depart from the familiar framework of the Insolvency Act 1986 (IA 1986) including under the Bank Special Administration Regulations 2011 (IB SAR) and the Payment and Electronic Money Institution Insolvency Regulations 2021 (pSAR).
- There have been a number of special administrations under the IB SAR and pSAR since the start of 2022, and the increasing body of case law in this area provides stakeholders with useful guidance and greater certainty as to the applicable principles.
- In addition to the bespoke administration frameworks in the IB SAR and the pSAR, lawyers and insolvency practitioners are also required to grapple with pre-administration safeguarding rules in FCA's Client Asset Sourcebook (CASS), the Payment Services Regulations 2017 and the Electronic Money Regulations 2011.

This is a sector which has seen significant activity in recent years. According to the Financial Conduct Authority (FCA), since the start of 2022 there have been five special administrations under each of the IB SAR and the pSAR:

ENTITY	TYPE	DATE
Xpress Money Services Ltd	pSAR	11 February 2022
Sova Capital Ltd	IB SAR	3 March 2022
Sberbank DIB (UK) Ltd	IB SAR	1 April 2022
WealthTek LLP	IB SAR	6 April 2023
Monneo Ltd	pSAR	30 May 2023
Blankstone Sington Ltd	IB SAR	13 October 2023
IBP Markets Ltd	IB SAR	13 October 2023
Rational Foreign Exchange Ltd	pSAR	29 November 2023
Silverbird Global Ltd	pSAR	13 March 2024
LCC Trans-Sending Ltd	pSAR	18 June 2024

INTRODUCTION

Administrations are procedural in nature. Their purpose is to rescue a company if possible, and if not to act as a class remedy or collective enforcement mechanism for creditors as a whole or at least for secured and preferential creditors. Special administrations introduce different objectives and provide additional tools to facilitate their achievement. In particular, the introduction of the Investment Bank Special Administration Regulations 2011 (IB SAR) (and its subsequent amendment following the Bloxham review) was driven by a desire to achieve a more efficient and timely identification, protection and return of client assets than might be possible under an ordinary insolvency process. The Payment and Electronic Money Institution Insolvency Regulations 2021 (pSAR) is directly modelled on the IB SAR and was introduced following UK Treasury concerns as to the length of time it was taking for insolvent payment institutions to return customer funds.

Since administrations are procedural in nature, save where the rules provide otherwise, creditor outcomes are conditioned by pre-administration entitlements. That means that, if an asset does not beneficially belong to the firm before administration, it cannot form part of the insolvent estate upon administration. Policymakers have used proprietary structures – in particular, statutory trusts – to protect certain classes of creditors so far as possible from the effects of special administrations. Since insolvency is a zero sum game, this involves a transfer of credit risk away from such creditors to those who are not beneficiaries under the statutory trust or similar proprietary arrangement.

CASS

The FCA's Client Asset Sourcebook (CASS) provides in broad terms that money received by firms from clients or held for clients in connection with certain regulated activity is held on trust for the purposes of the CASS rules, for clients according to their respective interests, for the costs of distribution after a firm's failure, and, if there is any surplus, for the firm itself: CASS 7.17.2.

The leading case remains *Re Lehman Brothers International (Europe) (in administration)* [2012] UKSC 6, [2012] 3 All ER 1. Lehman Brothers International (Europe) had not complied with CASS segregation requirements prior to administration. The Supreme Court held that the monies were held on trust from the moment when first received and not when segregated into client accounts. The difficulty then was whether distributions from client accounts should be to all clients or only those whose monies had been segregated. The CASS rules were ambiguous on this. A minority of the court favoured limiting the distribution to those whose monies had been segregated, which would be in line with orthodox trust principles. But the majority adopted a purposive interpretation of the rules that would permit a distribution to all clients so that all could benefit to some extent from CASS protection.

Proprietary entitlements under CASS 7.17.2 can be waived or modified by the FCA under s 138A of the Financial Services and Markets Act 2000. This has led to the development of two types of orders for the distribution of client monies.

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First, an orthodox *Re Benjamin* order can be made which protects the firm and its insolvency officeholders from liability for a wrongful distribution where the proprietary claim is only notified after the bar date directed by the order but does not vary the underlying beneficial interests in the monies. That means, in principle, that the recipient of the monies could face an equitable proprietary claim (although in practice there may be defences available).

Second, there are *Re Alpari* orders, named after an unreported case and given prominence by the decision in *Re Pritchard Stockbrokers Ltd (in special administration)* [2019] EWHC 137 (Ch). A *Re Alpari* order approves an application by the firm and its insolvency officeholders to the FCA to use its powers under s 138A to extinguish beneficial interests after the bar date. This removes the risk of subsequent equitable proprietary claims.

THE PSR AND THE EMR

A recent controversy has been whether the safeguarding provisions for customer funds in the Payment Services Regulations 2017 (PSR) and the Electronic Money Regulations 2011 (EMR) create a statutory trust for the benefit of the relevant customers in the same way as CASS. The obvious difficulty with that view is that CASS expressly refers to the creation of a trust whereas the PSR and EMR do not. Nonetheless, in *Re Supercapital Ltd (in administration)* [2020] EWHC 1685 (Ch), the court was persuaded that there was sufficient functional equivalence between the provisions of the PSR and CASS that the PSR ought to be treated as creating an implied statutory trust for the benefit of relevant customers. Although *Re Supercapital* was not a contested application, and there were obvious problems with the court's reasoning, after that judgment the FCA took the position that funds held pursuant to the PSR and EMR were subject to a statutory trust.

The EMR is, if anything, an even weaker case for the imposition of a statutory trust than the PSR because the EMR does not even require segregation of funds in all cases; it is open to firms to use insurance and guarantee arrangements for safeguarding purposes. In *Re ipagoo LLP* [2022] EWCA Civ 302, [2022] 2 All ER (Comm) 813, and having heard FCA submissions to the contrary, the Court of Appeal held that no statutory trust arose by the provisions of the EMR given:

- the ability to safeguard under those regulations without segregation;
- segregation *per se* is in any event insufficient to create a trust; and
- the priority created for the return of funds to electronic money holders is better analysed as a secured interest over the asset pool, alternatively as an amendment to the creditor priorities created by the IA 1986, rather than as a statutory trust.

Although *Re ipagoo* was concerned only with the EMR, the Court of Appeal cast doubt on the analysis of the PSR in *Re Supermarket*, and two subsequent first instance decisions have confirmed that the analysis in *Re ipagoo* applies equally to the PSR:

- *Re Allied Wallet Ltd (in liquidation)* [2022] EWHC 1877 (Ch);
- *Re OneStopMoneyManager Ltd (in liquidation)* [2024] EWHC 369 (Ch).

In *Re Allied Wallet*, the court appeared to prefer the Court of Appeal's alternative non-proprietary analysis as to the conceptual basis on which customers are given priority to their funds as creditors. This is attractive. As noted in the final Bloxham report, and demonstrated by the majority decision in *Re Lehman Brothers International (Europe)*, general property and trust law concepts are increasingly difficult to apply in the modern financial services context. It is more straightforward to confer priority on customers directly through exceptions to the usual rules on distributions than indirectly through creating proprietary entitlements. It also more naturally fits with the decision in *Re Allied Wallet* that:

- the costs incurred in respect of gathering in and distributing a particular PSR or EMR asset pool are to be borne by that pool and not the wider estate; and
- where asset pools cannot be fully reconstituted using non-safeguarded assets, the pools are to share those assets rateably in proportion to their shortfalls.

IB SAR

An IB SAR has different objectives to a normal administration:

- Objective 1 is to return client assets as soon as reasonably practicable.
- Objective 2 is for timely engagement with market infrastructure bodies and regulators.
- Objective 3 is to rescue the bank as a going concern or wind it up in the interests of creditors.

Unlike the order of priorities given to the objectives of an ordinary administration, there is no automatic ranking as between these three objectives, and the administrator can prioritise as he or she thinks fit, unless the FCA directs otherwise.

1. Obtaining a special administration order

An IB SAR can only be commenced by court order; there is no out-of-court process. The grounds are:

- (A) that the investment bank is, or is likely to be, unable to pay its debts;
- (B) that it would be fair to put the investment bank into special administration; and
- (C) that it would be expedient in the public interest to put the investment bank into special administration.

In *Re Sberbank CIB (UK) Ltd* [2022] EWHC 1059 (Ch), the court confirmed that ground A includes debts that will fall due in the reasonably near future and that "fair" in ground B means "just and equitable" (consistent with s 93(8) of the Banking Act 2009). Further, there is overlap between the grounds. In *Re WealthTek LLP* [2023] EWHC 2602 (Ch), the application was not made on the basis of ground A but the court accepted that concerns about solvency nonetheless remained relevant in the assessment of what was fair under ground B, not least that the commencement of a special administration would provide assurances

to clients with the certainty of an orderly wind-down and distribution of client monies.

Special administration orders are typically sought at short notice and often given with *ex tempore* reasons, but a few transcripts of judgments are available and provide some useful pointers. In respect of the recent IB SARs noted in the table above, in addition to *Re Sberbank* and *Re WealthTek*, judgment is also available in *Re Sovo Capital* [2022] EWHC 814 (Ch). Those three judgments confirm that the court will be focused on:

1. the jurisdiction of the court, ie that the firm falls within the scope of the 2011 Regulations;
2. the standing of the applicants (in *Re Sovo Capital* and *Re Sberbank* the applicants were directors; in *Re WealthTek* the applicant was the FCA);
3. the grounds for special administration; and
4. compliance with the procedural requirements under the Investment Bank Special Administration (England and Wales) Rules 2011.

Once those four matters have been satisfied, the court then has a discretion to order a special administration, which it will exercise having regard to the objectives of a special administration and whether they are appropriate in the circumstances. *Re WealthTek* confirms that solvency is a relevant factor again at this stage.

Where the FCA is not the applicant, its support for a special administration will still carry significant weight with the court when considering the exercise of its discretion. One persisting uncertainty are the notification requirements under the 2011 Regulations, which state that the FCA should be notified of an intended application for an “administration order” and either the FCA consents to the application or two weeks have elapsed since notification. The court has not yet determined whether the reference to “administration order” includes an order for special administration or is limited to an ordinary administration. The FCA has taken the position that it does not apply to special administrations, and that seems right as a matter of textual analysis of the regulations, although in *Re Sberbank* the court said that it could “see the arguments both ways”.

2. Distributions and transfer of client assets and monies

Since the implementation of the Bloxham recommendations, the key tool in ensuring a speedier return of client assets and monies has been the use of bar dates. A “soft” bar date can be set by administrators to establish the universe of claimants interested in the distribution of client assets or monies. For client assets, an administrator is then required to make an application for approval of a distribution plan. Once an approved distribution is made, it cannot be unwound; the order has a substantive effect on underlying beneficial interests like a *Re Alpari* order. The administrator can also apply for permission to set a “hard” bar date which enables residual unclaimed client assets to be transferred into the general estate of the investment bank.

Re SVS Securities plc (in special administration) [2020] EWHC 1501 (Ch) stated the following principles for approval of a client asset distribution plan. The court’s first concern is that, in line with Objective 1, the distribution plan provides a fair and reasonable means of effecting the distribution of client assets. If so, the court will then consider the position of the creditors’ committee, other creditors, the administrators and the FCA. If all relevant persons have been given a proper opportunity to make representations and either have supported the plan or at least not opposed it, then the court is likely to approve the plan. In *Re Blankstone Sington Ltd (in special administration)* [2024] EWHC 1111 (Ch) that formulation was treated as authoritative, although (as explained below) a further gloss has since been added in the pSAR context.

For client monies, the position is slightly different. After the expiry of a soft bar date, a distribution can be made without the approval of the court (although if the distribution is not as prescribed by CASS that will require the FCA to exercise its power under s 138A). However, the special administrators may seek the reassurance of a declaration or directions to confirm the position, as they did in *Re SVS Securities* and *Re Blankstone Sington*. In *Re SVS Securities*, and again in *Re Sovo Capital* [2023] EWHC 1690 (Ch), the administrators also sought and obtained an order for the adjudication of CASS disputes since the rules themselves make no such provision. In *Re Blankstone Sington* this was described as a “well established practice”. However, the court will be astute not to approve a process which limits its own jurisdiction ultimately to determine a CASS dispute. In *Re Blankstone Sington*, the court expressed unhappiness about some proposed wording that would prevent the court retrospectively extending time to allow determination of a CASS dispute; rather than contest the point the administrators removed that wording, even though similar cut-off provision previously had been included in *Re SVS Securities* and *Re Sovo Capital*.

It is not untypical for a distribution plan to involve a bulk transfer of client assets and (subject to waiver under s 138A) client monies to another authorised firm; that was the approach taken in both *Re SVS Securities* and *Re Blankstone*. In *Re Sovo Capital* [2023] EWHC 452 (Ch), there was again a bulk transfer of a portfolio of Russian securities (about 87% of its total securities). However, it was not to another authorised firm but rather to one of the firm’s major unsecured creditors as a sale in consideration for waiver for its claims against the estate. Unsecured credit bidding is a feature of US bankruptcy law but novel for UK insolvency law. No doubt for that reason, the transaction was made conditional on court approval, and the court’s decision to grant that approval attracted significant market attention. *Re Sovo Capital* breaks new ground in confirming that such a transaction is within the power of administrators and does not breach the *pari passu* principle, being a sale not a distribution. However, it remains to be seen whether unsecured credit bids become a feature of IB SARs beyond unusual circumstances such as *Re Sovo Capital*, where Western sanctions against Russian interests meant that there was no market for the sale of the Russian securities. In normal circumstances, the court would likely expect

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Biog box

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to be satisfied not only that the accepted unsecured credit bid is the best available (requiring a competitive bid process) but also represents a clearly better outcome for creditors than an orthodox distribution.

The *Re Sova Capital* special administration has also generated the first case law on hard bar dates for IB SARs: [2023] EWHC 2690 (Ch). The facts underpinning that application show the utility of this tool. When entering special administration, the firm had 196 CASS clients of which 52 were active and 144 were dormant. 18 months on from the start of the special administration, 136 clients remained unresponsive (representing about 0.06% of the class by value). The special administrators had sought to contact clients by email, post, tracing exercises, press advertisements and through posts on the firm's website. In those circumstances, the court was satisfied that the special administrators had taken reasonable measures to contact clients and that there was no reasonable prospect of CASS claims arising after the hard bar date. A hard bar date was in the interests of Objective 1 because it gave certainty as to the universal of eligible creditors, enabling the special administrators to distribute its reserve of nearly \$25m to those 60 clients who had engaged in the IB SAR process and any surplus could be added to the estate available to other creditors.

PSAR

In 2020, the UK Treasury consulted on extending the tools available in an IB SAR for payment and electronic money institutions. The principal reason for the extension was a concern that funds were not being returned quickly enough to customers: the Treasury gave the example of three 2018 insolvencies where there still had been no distribution by the end of 2020. The reforms were formulated shortly after the decision in *Re Supercapital* and so premised (wrongly) on customer funds being held on trust in the same way as client monies under CASS. The grounds for a pSAR and its objectives are materially the same as for the IB SAR. There are a small number of provisions of the 2021 Regulation which therefore do not make sense, although the pSAR still functions as intended.

The only available judgment on an application for an order to commence a pSAR is the transcript of the unreported decision in *Re Monneo Ltd*. The judgment is short and does not engage with the structure of the analysis that has been developed in the context of applications to commence an IB SAR, but logically that same structure should be adopted in this context. The court noted, however, that it would exercise its discretion where the outcome of such an order would be "positive" for those concerned. That introduces the idea of relevant comparator – ie what would happen in the absence of a pSAR – although perhaps that was implicit in some of the earlier IB SAR applications. This should be treated with caution since it can be entirely unclear when seeking a special administration order (especially in the context of an urgent application) what the relevant comparator would be and whether it would lead to better or worse outcome. Of course, if an applicant can articulate that case that will further bolster its position on the

exercise of discretion, but the absence of such evidence in most cases cannot fairly be held against the applicant.

There is also presently only one judgment on the distribution plans in the context of a pSAR: *Re Xpress Money Services Ltd* [2023] EWHC 1120 (Ch). The court followed the principles developed in case law on distribution plans for IB SARs but added a gloss to the first stage of the approach adopted in *Re SVS Securities*. This was to emphasise the importance of timing: the distribution plan must not just provide a fair and reasonable means of effecting the distribution of client assets, but to do so as quickly as reasonably practicable. The court was satisfied that this threshold was met on the proposals before it in *Re Xpress Money Services*. It also considered that, while the administrators should be authorised to set a hard bar date, it did not propose to prescribe when it should be given the special administration had been on foot for two years and the sums in question were small. The court noted that it might take a more hands-on approach in other circumstances and actually set the hard bar date (and, as noted above, that is what it did in *Re Sova Capital* in the context of the IB SAR).

CONCLUSION

The rules governing the failure of investment banks, payment and electronic money institutions are amongst the most complicated in insolvency law. Lawyers and insolvency practitioners are required to grapple with both pre-administration safeguarding rules in CASS, the Payment Services Regulations 2017 and the Electronic Money Regulations 2011, and bespoke administration frameworks in the IB SAR and the pSAR. The purpose of this article has been to show that the increasing body of case law in this area provides stakeholders with useful guidance and greater certainty when applying for an IB SAR or a pSAR and thereafter seeking distributions of client assets and monies. ■

Further reading:

- The special administration regime for payment services and electronic money institutions, and a first distribution plan approved in *Re Xpress Money Services Ltd (in special administration)* (2023) 3 CRI 79 <https://fz3i.short.gy/yAkKDa>
- Investment banks, sanctions, and the merits of special administrators: the case of *Sberbank UK* (2022) 5 CRI 147 / <https://fz3i.short.gy/1OCN6H>
- Lexis+ Restructuring and insolvency: Practice note: Special administration for investment banks <https://fz3i.short.gy/mQMSXd>