Trustees: Tracing and the Rule in Clayton's Case

Mark Pawlowski takes a critical look at the rule in Clayton's Case and asks whether it still has application in the context of a tracing claim

Where a trustee (or other fiduciary) wrongfully purchases an asset by means of moneys from separate trust funds or an innocent volunteer buys property using his own money and trust money, the basic principle is that each innocent contributor has an equal equity so that they will share pari passu (i.e., rateably), neither having priority over the other. Each will be entitled to a charge on the asset for his own money. Moreover, as against the trustee, they can both agree to take the asset itself, thereby becoming tenants in common in shares proportional to the amounts for which either could claim a charge: *Sinclair v Brougham* [1914] AC 398.

The orthodox view, however, is that the pari passu principle falls to be modified when the mixing takes place in a current (running) bank account. Thus, under the so-called rule in *Clayton's* case (*Devaynes v Noble, Baring v Noble* (1816) 1 Mer 572; [1814-23] All ER Rep) where a trustee mixes the funds of two separate trusts, or an innocent volunteer mixes trust money with his own money, in an active (running) bank account, withdrawals out of the account are presumed to be made in the same order as payments in (i.e., first in, first out). The rule has been criticised both judicially and academically and is the subject of a number of exceptions.

Arbitrary results

It has been recognised for some time that a rigid application of *Clayton's* case, although providing a rule of convenience, can produce results of a highly arbitrary nature. To take a simple example, a fraudulent trustee pays £5,000 from trust fund A into his current bank account (where there are no other moneys) and next day pays the same amount into the account from trust fund B. A few days later, he dishonestly withdraws £5,000 for his own use. Applying *Clayton's* case, the entire loss will fall on trust fund A because A's money was the first to be paid in and, hence, is deemed to be the first out. As early as 1923, an American judge ventured to suggest that "to adopt [the fiction of first in, first out] is to apportion a common misfortune through a test which has no relation whatever to the justice of the case": *Re Walter J Schmidt & Co, ex p Feuerbach* (1923) 298 F 314, at 316, per Judge Learned Hand.

The point was specifically addressed in *Barlow Clowes International Ltd v Vaughan* [1992] 4 All ER 22 where the Court of Appeal refused to apply the rule to a situation where moneys, which had been paid towards various investment plans, were misapplied leaving a substantial shortfall in the amount available for distribution to the investors. Although refusing to overrule *Clayton's* case, the Court of Appeal concluded that, where the application of the rule would be impractical or would result in injustice between the competing parties, or would be contrary to the parties' (express or implied) intention, it fell to be displaced if a preferable alternative method of distribution was available. In *Barlow Clowes*, it was apparent that the investors had intended to

participate in a collective investment scheme by which their moneys would be mixed together and invested through a common fund. Accordingly, the “first in, first out” rule was clearly inappropriate and, instead, the assets available for distribution were ordered to be shared pari passu among all the unpaid depositors rateably in proportion to the amounts due to them.

Interestingly, Dillon LJ concluded, at 33, that it was not for the Court of Appeal to reject the long-established practice that the rule in *Clayton's Case* was to be applied when several beneficiaries' monies have been blended in one bank account and there is a deficiency. Instead, his Lordship thought the rule did not apply because the fund was a common fund, and not to be allocated to individual investors. Woolf and Leggatt LJJ, on the other hand, agreed with the comments of Learned Hand J in *Re Walter J Schmidt & Co*, referred to above, that to adopt the fiction of first in, first out, was to apportion a common misfortune through a test which had no relation whatever to the justice of the case. In particular, Woolf LJ's view, at 39, was that *Clayton's Case* did not always have to be applied. The use of the rule was a matter of convenience and, if it would result in injustice (in the instant case, as between investors), it would not be applied if there was a preferable alternative. Leggatt LJ, whilst reaching the same result, preferred to base his decision on the fact that the investors were deemed to have intended their money to be dealt with collectively and that the rule in *Clayton's Case* had nothing to do with tracing and was a rule of convenience only, but that it was not open to the Court of Appeal to disregard it unless there were an actual or presumed intention that it should not be applied.

Trustee mixing trust money with his own money

It is apparent that the rule in *Clayton’s* case will also have no application where the trustee (or other fiduciary) mixes trust money with his own money in his bank account. Here, the principle is that the trustee will be presumed to draw out his own money first until his own money has been exhausted, regardless of the order in which the moneys were paid into the account: *Re Hallett’s Estate, Knatchbull v Hallett* (1880) 13 Ch D 696. The rationale is that the trustee is presumed not to be committing a breach of trust by withdrawing money from the account and, if the trustee does withdraw money to purchase a worthless asset, the beneficiary will not be affected. Once, however, the trustee exhausts his own moneys from the account, the competing interests of any innocent beneficiaries will ordinarily be determined by applying the first in/first out rule.

Other exceptions to the rule

The rule has also been held not to apply where a specific withdrawal is earmarked as trust money. Thus, in *Re Diplock’s Estate, Diplock v Wintle* [1948] 1 Ch 465, a bequest to the National Institute for the Deaf, which had been placed by the charity in a different account, was treated as “unmixed” and, therefore, not subject to *Clayton’s* case. Clearly, the rule will also not apply to a mixture of tangible property or where the mixing takes place in a bank account other than a current account. In both these situations, the mixture must be shared pari passu. Similarly, the rule cannot apply if the precise sequence of payments into the account cannot be identified:

Re Eastern Capital Futures Ltd [1989] BCLC 371. In *El Ajou v Dollar Land Holdings (No 2)* [1995] 2 All ER 213, at 222, Robert Walker J said that in *Barlow Clowes* the Court of Appeal had recognised that a "first in, first out" method of distribution may not be appropriate for those who had the common misfortune of falling victim to a large scale fraud.

The presumed intention of the parties

In *Barlow Clowes*, Woolf LJ, at 39, drew attention to the fact that the rule had not been applied in a number of different circumstances - he summarised its limited role in the following terms: "The rule need only be applied when it is convenient to do so and when its application can be said to do broad justice having regard to the nature of the competing claims." His Lordship also recognised that a common theme running through the case law was that the rule would not be appropriate in many cases because of the presumed intention of the parties. This was a crucial factor in the *Barlow Clowes* (where there was a common pooling of funds and a collective misapplication) and also featured heavily in *Russell-Cooke Trust Co v Prentis* [2002] EWHC 2227 (Ch), where Lindsay suggested that it might be more accurate today to refer to *Clayton's* case as the exception, rather than the rule, in so far as it could now be displaced by "even a slight counterweight". Not surprisingly, his Lordship refused to apply it in determining the question of ownership of funds in a solicitor's account received for use in an investment scheme, preferring to distribute the various contributions to the scheme rateably amongst the respective investors.
In arriving at this conclusion, his Lordship held that *Clayton's Case* did not apply if there were circumstances from which a counter-intention could be presumed. Such relevant circumstances could include acts and omissions after the investor had made his investment and also the injustice between investors if the rule were to be imposed. According to Lindsay J, the rule could be easily displaced given the existence of an available counterweight. In *Russell-Cooke* itself, it was quite obvious that payments out of the account over the period of its operation showed a pattern of allocation which did not reflect a sequence whereby a payment out should be allocated to an earlier payment into the account. On the contrary, allocation was often totally out of step with the sequence in which payments in had been made. On the facts, therefore, the pari passu approach operated least unfairly in distributing loss on the account.

More recently, in *National Crime Agency v Robb* [2015] Ch 520, the claimants were held to establish a proprietary interest in the relevant fund by tracing their payments into the account that held the fund in the UK. For the tracing exercise, it was practically necessary and consistent with the investors' intentions to adopt a pro rata approach, which meant that each of the claimants' shares were to be calculated by establishing their individual payments as a percentage of the total investors' payments and applying that same percentage to the fund: see also, *Charity Commission for England and Wales v Framjee* [2015] 1 WLR 16. In *Sheppard v Thompson*, unreported, December 3, 2001, Hart J conveniently summarised the position in the following terms:

> "Where the proprietary remedy is asserted and a mixed substitution has taken place via a bank account the beneficiary's rights to trace will depend upon whether the fund concerned consists entirely of money contributed by innocent contributors. If so, the *prima facie* rule is that known as the rule in *Clayton's case*, but in appropriate

> circumstances this may yield to considerations of practicability, arguably of fairness, or of the presumed intention of the contributors."

A similar approach was taken in the earlier case of *Commerzbank AG v IMB Morgan plc* [2004] EWHC 2771 (Ch), where it was held that, as the amount of the claims far exceeded the sums in the accounts, the claimant beneficiaries would be paid pari passu, according to the amount of their contributions. Lawrence Collins J concluded that it would be both impractical and unjust to apply the rule in *Clayton's Case*. To adopt the fiction of first in first out would be to apportion a common misfortune through a test that bore no relation to the justice of the case. His Lordship stated, at [49]-[50]:

> "Part of the funds have been withdrawn on the instructions of IMB Morgan and replaced with other funds supplied by innocent claimants. Accordingly, there has been mixing (and payment away) of the money held on trust for the claimants. But it would be an extremely onerous (and perhaps impossible task) to determine what sums IMB Morgan has paid away. That is because the nature of a correspondent bank account is such that debits to the account may not necessarily be equated with payments out by IMB Morgan. Some of the debits may be payments to another account held by IMB Morgan, or payments to persons who hold on behalf of IMB Morgan. For example, there are in August 2001 debits of $100,000 (transfer to Bank Nigeria), $250,000 and £25,000 (transfers to Platinum Bank Ltd), $500,000 (Citizens International Bank Ltd). I am satisfied that the rule in *Clayton's Case* should not apply here, because it would be both impracticable and unjust to apply it. The only fair way to share the balances on each of the Accounts would be in proportion to the claims on the respective Accounts."

His Lordship also alluded to the Commonwealth position where the rule in *Clayton's Case* had been held in Canada and Australia not to apply to competing beneficial entitlements to a mingled trust fund where there have been withdrawals from the fund: see, *Re Ontario Securities Commission and Greymac Credit Corp* (1986) 30 DLR (4th) 1, (Ontario Court of Appeal), and (1988) 52 DLR (4th) 767, (Supreme Court); *Re French Caledonia Travel Service Pty Ltd*, (2003) 204 ALR 353.

Points for the practitioner

1. The rule in *Clayton's* case, despite being potentially capricious and arbitrary (being based purely on a coincidence of time), continues to have application in the context of competing beneficial claims to a mixed fund in a running account.

2. However, the decision in *Russell-Cooke* and other similar cases illustrate the modern judicial trend of limiting the effect of *Clayton's* case. The primary mechanism being adopted for this purpose is that of the parties' presumed or inferred intention, although the overall injustice and complexity surrounding the operation of the rule, particularly in

cases involving substantial funds and a large body of investors, are clearly also governing principles.

3. Priority in time, although once seen as a convenient basis for allocation of payments between competing contestants, is now viewed as anomalous and irrational. The problem is that (at least at Court of Appeal level), the judiciary has declined the invitation to disregard the rule altogether in the present context. It must be left, therefore, to the Supreme Court to examine the position afresh at some future date.

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