A critique of the rule in *Clayton's* case.

> "It might be suggested that the corollary of treating two claimants on a mixed fund as interested rateably should be that withdrawals out of the fund ought to be attributed rateably to the interests of both claimants. But in the case of an active banking account this would lead to the greatest difficulty and complication in practice and might in many cases raise questions incapable of solution. What then is to be done? In our opinion, the same rule as that applied in Clayton's case should be applied...It has been applied in the case of two beneficiaries whose trust money has been paid into a mixed bank account from which drawings were subsequently made...In such a case both claimants are innocent, neither is in a fiduciary relation to the other...the same occurs where the claimants are beneficiary and volunteer...accordingly...the same principle should be adopted."[1]

Lord Greene MR's remarks (above) typify the confusion still surrounding the trusts law topic of tracing. Given that many students, including myself, often get confused with the concept of tracing, I was very keen on writing an article to provide a critique of the law in this area. As for prospective trusts lawyers, they will not be so keen in hearing that such difficult legal issues are not circumvented in practice, the reality being that the law of tracing is "complicated, littered with inconsistencies and possibly now verging on a state of disarray"[2].

This article will focus on tracing into a mixed fund in equity and, more specifically, the rule in *Clayton's* case, or to give it its full legal name; *Devaynes v Noble (Clayton's case)*[3]. The rule provides a common law presumption in relation to the distribution of monies from a mixed fund in a bank account. It is based on the traditional, yet simple, principle of first in, first out to determine the order in which payments are made from an account.

The quote above clearly supports the application of the rule in *Clayton's* case, but central to his Lord Greene MR's words is the complications in such circumstances where trust monies held for the benefit of two or more innocent claimants are mixed into one single bank account. For example, X, a trustee, puts £1000 of Trust A money into an empty bank account on the 1st June, and puts £500 of Trust B money into the same account on 2nd June. The trustee then withdraws £1200 in breach of trust and spends it. The £1200 has dissipated and can, therefore, not be claimed. The legal issue is whether Trust A or Trust B is entitled to claim the remaining £300. The beneficiaries of both trusts will attempt to claim the £300. As both claimants are innocent there equities are equal and therefore, the "fund ought to be attributed rateably", suggesting that each would be awarded £150 each. His Lordship argues

that this would cause incredible difficulty in practice. This is because in reality current accounts are very active and the court might be dealing with large amounts of transactions. Consequently, it is very hard or impossible to disentangle the funds from the account. Hence, his Lordship concludes that the presumption from *Clayton's* case should be applied. Therefore, the trustee is regarded as having taken out of the fund whatever had been put in, on a first in, first out basis so that the first monies to go into the account will be withdrawn first. Thus, in the example above Trust B will be entitled to claim the remaining £300. Trust A will argue that their equities are equal and, therefore, the result of *Clayton's* case is unfair. Consequently, this "rule of convenience" has been a very contentious topic in subsequent case law, being subject to criticism.

In considering the words of Lord Greene MR, it will be argued that the rule in Clayton's case should be displaced so that it is only applied where it would be impractical to apply any other rule. It will be argued that the pari passu principle should be applied in the circumstances outlined by his Lordship. Thus, in *Barlow Clowes International Ltd (In Liquidation) v Vaughan*[4] the court refused to apply *Clayton's* rule to a situation where monies which had been paid towards various investment plans because it would have meant that the earlier investors would bear the loss. Although the court refused to overrule *Clayton's* case, the court concluded that the rule should not be applied where the application would be impractical or result in injustice between the parties, or would be contrary to the parties' express or implied intention. In doing this, the court held that the investors' monies would be mixed together and invested through a common fund, and considered different alternative basis of distributions. First, there was the "rolling charge" or North American[5] method (*Re Ontario Securities Commission*[6]). Under this approach, the investors would have shared the loss in proportion to their investment immediately before each withdrawal. This would have produced the most just result, but was rejected as being impracticable in the light of the large number of investors (11,000) involved. The other alternative was to distribute the common fund pari passu, i.e. bearing the loss proportionately according to their initial investment. This method of distribution was the preferred one in the circumstances of the case.

It is quite clear that Lord Greene refers to the pari passu method as creating "difficulty and complication". However, in strong disagreement, it is submitted that *Clayton's* case is equally, if not even more, difficult. It must be remembered that the first in, first out principle in that case is merely a presumption and can, therefore, be displaced. The problem, however,

is that presumptions are often displaced in different circumstances[7]. The result of this is that application of such a rule is both "capricious and arbitrary"[8]. Hence, his Lordship, preferring *Clayton's* rule, got it wrong by saying that the pari passu method of distribution is both difficult and complex. In agreement with Woolf LJ in *Barlow Clowes*, it is submitted that this method is "the virtue of relative simplicity".

Furthermore, Lord Greene MR did not seem to recognise that the application of the *Clayton's* case would be unjust in almost all circumstances such that it will only apply in the most exceptional circumstances. In *Barlow Clowes*, Dillon LJ recognised that the alternative approach of applying the pari passu principle could work just as much injustice to a later investor (as opposed to an early investor) whose contribution was still likely to be included in the relevant account[9]. Leggatt LJ went even further, considering that the rule has nothing to do with tracing[10]. His Lordship also described the rule as potentially capricious and arbitrary. Woolf LJ summarised *Clayton's* rule's limited role: "The rule need only be applied when it is convenient to do so...having regard to the nature of the competing claims"[11], recognising 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.

It has been recognised for some time that a rigid application of *Clayton's* case can produce results of a highly arbitrary nature. The judgment in *Re Diplock* was delivered on 9th July 1948 and it is quite difficult to see why Lord Greene MR was not aware of any "adverse" criticism of *Clayton's* case. It was as early as 1923, in an American case[12], where Hand J suggested that the rule is a fiction and has no relation whatever to the justice of the case[13]. There is a clear tension that features in the case law, between a judicial disliking of *Clayton's* case and a reluctance to overrule the case.

In *Russell-Cooke Trust Co v Prentis (No. 1)*[14], there was no "common misfortune" operating so as to override the specific rights of five investors (*Barlow Clowes* distinguished). The funds, however, were distributed pari passu in the same way as in *Barlow Clowes*. Lindsay J expressed that "it might be more accurate to refer to the exception, rather than a rule, in *Clayton's* case". In addition, Collins J also refused to apply the rule in *Commerzbank Aktiengesellschaft v IMB Morgan plc*[15] as it was "impracticable and unjust".

The application of *Clayton's* case has also been criticised in the academic sphere. *Conaglen*[16] argues that the "convenient rule" in *Clayton's* case is redundant. He considers that if there is sufficient factual information to conduct the required analysis of *Clayton's* case, then there should be sufficient information to perform analysis of a "rolling charge", or at least a pari passu sharing. He argues that the choice between methods of allocation should depend upon the cost and practicability of applying each one on each set of facts. In addition, *Pawlowski*[17] argues that the presumption in Clayton's case is now "anomalous and irrational". He criticises the first in, first out principle, stating that the priority in time basis for the rule has "capricious consequences". It is, therefore, argued that Lord Greene MR's view of the position should be displaced and should only be endorsed as a last resort, where it would be impractical to apply the other methods of distribution.

Lord Greene MR also suggests that the unfair presumption in Clayton's case should apply where one claimant is a beneficiary and the other is a volunteer. For example, if X, a trustee puts £1000 of Trust A in an empty bank account and later, in breach of trust, withdraws and makes a gift to B for £1000, can Trust A trace the money back? His Lordship expressed that the same, first in, first out, rule should be applied. Thus, if B already has £1000 in his account and then cashes in the gift from X, he will have £2000 in the account. If B withdraws £1000 then Clayton's rule will presume that it is his money that was taken first, because of the FIFO basis. This is prejudicial to the volunteer who thinks he has been given a gift. The beneficiary of Trust A and B are both innocent and their equities are still equal. It is submitted that the same arguments as above apply here. The fund must be distributed pari passu or through the "rolling charge" method.

Ultimately, it is submitted that Lord Greene MR is mistaken. *Clayton's* case is based on priority in time; a presumption that may at one time have been convenient has developed into something quite different. Not only is the application of the presumption "capricious and arbitrary", but it is now viewed as "anomalous and irrational". The rule itself creates "difficulty and complication" because of its arbitrary nature. The recent decision in *Russell-Cooke Trust Co v Prentis* illustrates the continuing trend to limit the effect of *Clayton's* case. In agreement with Lindsay J in *Prentis*, "it might be more accurate to refer to the exception, rather than a rule" as the rule has to a large extent been displaced. The *Report of the Review Committee on Insolvency Law and Practice*[18] recognised the difficulties with the presumption in *Clayton's* case but refused the opportunity to abolish it. It is, therefore, hoped that the

Supreme Court will provide a defining judgment of the position at some point in the future. Until then, both students and lawyers are left with an unruly creature.

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[1] *Re Diplock* [1948] 1 Ch 465, per Lord Greene MR at 553.
[2] Breslin. J, *Tracing into an overdrawn bank account: when does money cease to exist?* (1995) Comp Law 16(10) 307-311.
[3] (1816) 1 Mer 572.
[4] [1992] 1 All ER 22.
[5] "'North American' because it is the solution adopted or favoured in preference to the rule in Clayton's case in certain decisions of the courts in the United States and Canada because it is regarded as being manifestly fairer" (*Barlow Clowes International Ltd (In Liquidation) v Vaughan* [1992] 1 All ER 22, per Woolf LJ at 35).
[6] (1986) 20 DLR (4th) 1.
[7] See *Re Registered Securities Ltd* [1991] 1 NZLR 545.
[8] Lord Goff of Chieveley and Gareth Jones, *The Law of Restitution*, 5th edition (London 1998), page 108.
[9] [1992] 1 All ER 22 at 32.
[10] *Ibid* at 44.
[11] *Ibid* at 39.
[12] *Re Walter J Schmidt & Co, ex p Feuerbach* (1923) 298 F 314.
[13] *Ibid* at 316.
[14] [2003] 2 All ER 478.
[15] [2005] 2 All ER (Comm) 564.
[16] Conaglen. M, *Contest between rival trust beneficiaries (Case Comment)*, (2005) CLJ 64(1) 45-48.
[17] Pawlowski. M, *The demise of the rule in Clayton's case (Case Comment)*, (2003) Conv, Jul/Aug, 339-345.
[18] (1982) Cmnd 8558.