APPROPRIATING THE ASSETS OF FAILED COMPANIES: TRACING IN EQUITY INTO A DIMINISHED FUND

Micheal McGrath BL analyses the recent High Court decision *In The Matter of Money Markets International Stockbrokers Ltd. (In Liquidation).* which considered the equitable concept of tracing.

Introduction

The law on how the loss should be borne as between the beneficiaries of a fund from which a person in a fiduciary capacity wrongfully takes money has been helpfully clarified by Laffoy J.'s judgment in *In The Matter of Money Markets International Stockbrokers Ltd. (In Liquidation).*[1] The question is in essence one of tracing the money invested in the fund into the diminished value of the fund, although in practice it arises as one of how the amount left in the fund should be appropriated amongst the investors.

Money Markets International Stockbrokers (MMI) was suspended by the Stock Exchange on 19th February 1999. The liquidator found that over £2.7 million was owed to clients but the amount available to satisfy this debt was under £1.5 million. On 18th February the applicant had lodged a sum of money to the client account of MMI in order to pay for shares purchased on his behalf by MMI. The applicant sought an order directing the liquidator to complete the transaction to buy shares with the amount that he had lodged, or, in the alternative, to return to him the money that he had lodged.

Background

Accounts of the law to be applied to this issue generally start with *Clayton's Case,* 1816.[2] This established the principle of 'first in, first out', which is best explained by an example. X contributes £10,000 to a fund containing no other money and the next day Y contributes £10,000 to that fund. If the following day the trustee of the fund wrongfully takes £10,000 from the fund the loss would be borne entirely by X. Such a result would benefit the applicant in *Money Markets* as the loss would be borne by persons who had lodged money in the client account before he had done. This result of the rule in *Clayton's Case* has been described by Goff and Jones in as 'capricious and arbitrary'.[3] In a passage quoted in Laffoy J.'s judgment the Chief Justice Keane writing extrajudicially described it as 'rough justice' and doubted whether:

> "the Court would now continue to apply *Clayton's case* (which has always been regarded as based on rather crude if convenient assumptions) to the case of competing claims of beneficiaries to money in a bank account."[4]

The dislike of the rule in *Clayton's Case* is not confined to academic commentaries on the law. In *Re Registered Securities Ltd.*[5] the New Zealand Court of Appeal stated 'The automatic application of the rule in *Clayton's Case* as between beneficiaries will not withstand scrutiny.'[6] It held that because the rule is a fiction based on presumed intent it cannot be allowed to work an injustice. Secondly, because it is based on presumed intent it must give way 'to an express contrary conclusion or to circumstances which point to a contrary conclusion'[7]

Woolf L.J.'s (as he then was) judgment in *Barlow Clowes International (in liquidation) v. Vaughan*[8] was a significant influence on Laffoy J.'s judgment. Woolf L.J. stated that the following *obiter dictum* of Judge Learned Hand accurately described the application of the rule to the case before him:

> "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."[9]

However, as Woolf L.J. noted, Hand J. applied the rule as he considered himself bound by precedent. The interaction between a judicial dislike of the rule on the one hand and a reluctance to explicitly overrule it on the other hand is characteristic of much of the case law in this area.

In *Barlow Clowes* the funds in two investment plans had been misapplied and when the company went into litigation there was a shortfall in the plans to which around 11,000 investors had contributed. The Court of Appeal discussed three ways of apportioning the loss between the investors:

1. The rule in *Clayton's Case*. This was considered impractical given the complexity of the accounts, and unfair by both Woolf and Leggatt L.JJ.
2. The 'rolling charge' or 'North American'[10] solution. A withdrawal from the account is considered to be a withdrawal in the proportion of the interests in the acount at the moment prior to the withdrawal. Although Woolf L.J. stated that this 'would produce the most just result'[11] given the complexity of the accounts in the present case all the parties accepted that the costs involved would be disproportionate even to the significant amount of money involved.
3. The *pari passu ex post facto* solution (as Woolf L.J. called it). All the available assets of the fund are divided between the beneficiaries proportionate to the amount that they have invested, disregarding the date of the each investment and the date of each unauthorised withdrawal. Woolf L.J. stated that this solution has 'the virtue of relative simplicity and therefore relative economy and also the virtue in this case of being more just than [the Rule in Clayton's Case].'[12]

Having decided that the latter solution was the better in principle of the two in issue Woolf L.J. discussed the authorities to ascertain whether there was binding precedent preventing him from applying that solution. Along with the other two judges (Dillon and Leggatt L.JJ.) he held that whereas there is a presumption in favour of applying the rule in *Clayton's Case* that presumption is rebuttable where its application would be impractical or unjust - in the case in hand it would not be applied because it would be contrary to the express or implied or presumed intention of the investors.

The other case that Laffoy J. relied upon in formulating the applicable legal principle was the Irish case of *Shanahan Stamp Auctions Ltd. v. Farrelly.*[13] In that case about £1.5 million pounds investors' money first of all had been placed in an investment fund for the purchase of stamps and secondly had been converted into goods (stamps). The value of the company's assets when it went into liquidation was under £500,000. One of issues was whether the rule in *Clayton's Case* should apply to a particular class of investors. Budd J. stated:

> "It may be that the rule in *Clayton's Case* does not apply beyond tracing in a bank account and the principle may have no application to property acquired by means of a mixed fund. But I prefer to deal with the situation, for safety's sake, as if the principle can properly be applied to the case of property acquired with such a mixed fund."[14]

Budd J. found that whereas it would be possible to apply the rule to deposits in the bank account it was not possible to know whose money had been withdrawn to purchase particular lots of stamps. As it was practically impossible to apply the rule he ordered a pro rata distribution.

The Judgment

From her discussion of *Shanahan, Barlow Clowes* and the passage from Keane C.J.'s book set out above Laffoy J. stated that:

> "The conclusion I draw from the authorities are that . . . in the case of a current account such as the account in issue here where trust funds sourced from various beneficiaries are mixed or pooled in the account it is settled law that as a general proposition the rule in Clayton's Case is applicable in determining to whom the balance of the account belongs. However, the application of the rule may be displaced in the particular circumstances of a case, for instance, if it is to be shown or to be inferred that it does not accord with the intention or presumed intention of the beneficiaries of the trust fund."[15]

"It would be a mistake to consider *Money Markets*, or indeed *Barlow Clowes,* as heralding a new approach to the law of tracing in equity. Although discussion of the rule in *Clayton's Case* has become a regular feature of the case law and academic commentary on this question there has been a strong tradition of the courts actually deciding cases, as courts of equity should, in the light of the justice of the case as between the parties. This is what Laffoy J. did on the facts of *Money Markets.*"

Laffoy J. stressed that she was not required to reach a conclusion as to how the balance was to be divided out between all the parties who had a claim to the funds in the account; she confined herself to considering the position between the applicant on the one hand and all other parties on the other hand. She held that even if Clayton's Case does not apply, on the facts the applicant had a better claim than the other investors. After holding that the liquidator did not have the power to complete the purchase of the

shares she therefore ordered that he repay the applicant the full amount transferred to the company.

Analysis

It would be a mistake to consider *Money Markets*, or indeed *Barlow Clowes,* as heralding a new approach to the law of tracing in equity. Although discussion of the rule in *Clayton's Case* has become a regular feature of the case law and academic commentary on this question there has been a strong tradition of the courts actually deciding cases, as courts of equity should, in the light of the justice of the case as between the parties. This is what Laffoy J. did on the facts of *Money Markets.*

Laffoy J. stated that the courts should apply a presumption that the rule in Clayton's Case applies, but that this can be displaced by the intention or presumed intention of the parties. If a presumption of some other intention displaces a presumption of the application of a particular rule this in effect says no more than that the courts should apply the intention or the presumed intention of the parties. That this has been done by courts of equity for years is evident from the following (non-exhaustive) list of what can be termed with respect to Laffoy J.'s formula of words as 'exceptions to the rule in Clayton's Case':[16]

a) The account is not a current account.[17]

b) The account was broken, i.e. one account was closed and a new account opened.[18]

c) Two accounts were kept.[19]

d) Negotiations between the parties showed that they intended that a particular transaction was to be treated separately from any other course of dealings between the parties.[20]

e) The account contains entries made in anticipation of payment.[21]

f) The account contains a blend of the trustee's money and trust money.[22]

g) Fraudulent withdrawals are made from the account.[23]

h) *ultra vires* transactions are made on the account.[24]

i) A balance remains in a charitable fund the purpose of which has been fulfilled.[25]

j) It is impossible to attribute the benefit of a particular contract to a particular client.[26]

k) Short term transfers were made from one account to another in order to earn a higher rate of interest rather than as an investment of a particular investor's money.[27]

Conclusion

The decision in *Money Markets* can be fully reconciled with the historical nature and purpose of equity: of doing what is right to bring about the fairest possible result between the parties. It is to be hoped that the Irish courts will continue to uphold the equitable tradition of adjudication and never be in the position in which Hand J. found himself in *Schmidt* of feeling obliged to apply a rule that he considered unjust.

1 High Court, unreported 28th July 1999.
2 *Clayton's Case: Devaynes v. Noble* (1816) 1 Mer. 572, [1814-23] All ER 1, 35 ER 781
3 Lord Goff of Chieveley and Gareth Jones T*he Law of Restitution* (5th ed.) (London: Sweet and Maxwell, 1998) 108
4 Keane *Equity and the Law of Trusts in Ireland* (Dublin: Butterworths, 1998) 286
5 [1991] 1 N.Z.L.R. 545
6 ibid. 553
7 ibid. 553
8 [1992] 4 All ER 22
9 *Re Walter J. Schmidt & Co. ex p. Feuerbach* 298 F. 314 (1923). This passage was also approved in Registered Securities.
10 So called because it is favoured by the courts in the United States and Canada, e.g., Re Ontario Securities *Commission and Greymac Credit Corp.* (1986) 55 OR (2d) 673.
11 [1992] 4 All ER 22, 35
12 ibid. 36
13 [1962] I.R. 386
14 [1962] I.R. 386, 442. In *Re Diplock* [1948] Ch. 465 the Court of Appeal stated that there is no justification for extending [the rule in Clayton's Case] beyond the case of a banking account. (at page 555)
15 Page 13 of the judgment
16 Some of these cases concerned the situation where there was a running account between only two parties and the issue was how payments should be appropriated, rather than the situation discussed in this article where funds are to be appropriated between different beneficiaries of a blended fund. These two situations have been treated similarly by the courts and there is no reason why principles set down in the one situation would not apply to the other.
17 *The Mecca* [1897] A.C. 286
18 *Re Sherry* (1885) 25 Ch. D. 692
19 *Bradford old Bank v. Sutcliffe* [1918] 2 K.B. 838
20 *City Discount Co. Ltd. v. McLean* (1874) L.R. 9 C.P. 692. See also *Henniker v. Wigg* (1843) 4 Q.B. 792
21 *Galula v. Pintus* (1911) 104 L.T. 574. The Plaintiff entered the amount of bills discounted in the account without waiting until they were paid.
22 Re *Hallett's Estate* (1880) 13 Ch. D. 696. There is a presumption that the trustee is honest and withdraws his own money first.
23 *Lacey v. Hill, Leney v. Hill* (1876) 4 Ch. D. 537 (affirmed on other grounds sub. nom. *Read v. Bailey* (1877) 3 App. Cas. 94)
24 *Blackburn Building Society v. Cunliffe, Brooks and Co.* (1884) 9 App. Cas. 857
25 *Re British Red Cross Balkan Fund* [1914] 2 Ch. 419. In Ireland that situation is now governed by Section 47 of the Charities Act, 1961, which allows such a fund to be applied cy-prËs.
26 *Re Eastern Capital Future Ltd. (in liq.)* [1989] B.C.L.C. 371
27 *Norton Warburg Investment Management Ltd. v. Gibbons* unrep. English H.C. 31st July 1981