TRACING, MIXING, AND INNOCENT CLAIMANTS

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Abstract

Faced with the problem that arises where multiple innocent claimants have contributed to a mixed fund that is now insufficient to meet all of their claims, English and Australian courts have suggested three solutions: (i) the rule in *Clayton's Case*; (ii) the 'simple pari passu' approach; and (iii) the 'rolling charge' or 'North American' approach. In *Caron v Jahani (No 2)* [2020] NSWCA 117, the New South Wales Court of Appeal adopted a simplified version of the third solution: the 'simplified rolling charge' approach. In doing so, the Court demonstrated that once the rule in *Clayton's Case* is (rightly) discarded, what remains is not simply a binary choice between the second and third solutions. We argue that English courts should revisit their approach to the problem posed at the outset by jettisoning the rule in *Clayton's Case* and by adopting the simplified rolling charge approach as the default position.

THE PROBLEM

A trustee misappropriates £1,000 from Trust A and £1,000 from Trust B and deposits the funds consecutively into her (previously empty) personal bank account. She then dissipates £1,000. The trustee then misappropriates £1,000 from Trust C and adds it to her account. She then dissipates £200, leaving a balance of £1,800. The trustee is now insolvent. The three beneficiaries (A, B, and C) seek repayment of £1,000 each. But with only £1,800 remaining in the account, their claims cannot each be satisfied in full. How is the fund to be distributed?

The problem illustrated by this example—how limited funds in a bank account are to be distributed among various persons asserting equitable proprietary rights against[1] the chose in action constituting the trustee's bank account—has been described as a 'classic insolvency conundrum'.[2] It typically arises where a person receives money from multiple individuals in circumstances which give rise to separate trusts in each of their favours and the amounts are deposited into a single bank account. The problem is one of tracing and mixing: how should the law deal with the 'common misfortune'[3] which arises where multiple innocent claimants have contributed to a mixed fund that is now insufficient to meet all of their claims in relation to it?

Three solutions[4] have been suggested:

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[1] See Ben McFarlane and Robert Stevens, 'The nature of equitable property' (2010) 4 *Journal of Equity* 1.

[2] *Caron and Seidlitz v Jahani and McInerney in their capacity as liquidators of Courtenay House Pty Ltd (in liq) & Courtenay House Capital Trading Group Pty Ltd (in liq) (No 2)* [2020] NSWCA 117.

[3] *Re Walter J Schmidt & Co* 298 F 314 at 316 [1] (1923).

[4] In some cases, effect has been given to an actual intention on the part of the trustee as to which beneficiary's money he or she has withdrawn: see *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361, 381–382 [64]; *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337, 379–382 [142]–[152]; *Caron v Jahani (No 2)* [2020] NSWCA 117 [76]. See too the 'new framework' advocated for in Christian Chamorro-Courtland, 'The Shortfall Conundrum: A New Framework for Allocating Losses in a Mixed Fund in Australia' (2019) 43 *Melbourne University Law Review* 133. We do not consider either of these approaches in this note due to constraints in time and space. We also do not consider the interesting issue which arises where investors contemplate or intend that their assets will be pooled, though readers interested should see *Caron v Jahani (No 2)* [2020] NSWCA 117 [26]–[28] and the cases cited therein.

(i) The rule in *Clayton's Case*[5] (the 'first in first out' rule), by which the first payments out of the account are attributed to the first payments into the account. In our example, A would recover nothing, B could assert a lien or a trust for £800, and C could assert a lien or trust for £1,000.

(ii) The 'simple pari passu' approach, by which each claimant is entitled to a proportionate share of the mixed fund corresponding to the size of their *initial* contribution. In our example, A, B, and C could each assert a lien or a trust for £600.

(iii) The 'rolling charge' or 'North American'[6] approach, by which each claimant is entitled to a proportionate share of the mixed fund corresponding to the size of their contribution, with that proportionate share being recalculated each time a withdrawal or deposit is made. In our example, A and B could assert a lien or trust for £450 each, and C could assert a lien or trust for £900.

In *Caron v Jahani (No 2)* ('*Caron*'),[7] the New South Wales Court of Appeal considered this problem on an application for directions by liquidators and opted for a version of the rolling charge approach. In doing so, the Court exposed and addressed a tension between (i) the solution traditionally favoured by courts in both England and Australia, the simple pari passu approach, and (ii) established principles of tracing, particularly the 'lowest intermediate balance' rule. But before considering the decision in *Caron*, it is necessary to explain in more detail the three possible solutions to the problem.

THREE POSSIBLE SOLUTIONS

(1) The rule in *Clayton's Case*

The first possible solution is the rule in *Clayton's Case*. There are two principal difficulties with applying that rule to cases involving mixed funds.

The first is that the rule, as a method of determining the rights of competing innocent claimants, is unjust, irrational, and arbitrary. Applying the rule in *Clayton's Case* to our example above, the dissipation of £1,000 is attributed to the deposit of £1,000 from Trust A, and the dissipation of £200 is attributed to the deposit of £1,000 from Trust B. The result is that A can assert no equitable proprietary rights and B can assert equitable proprietary rights for £800.[8] But the only difference between A and B is the timing of their contributions; both contributions were made *before* the £1,000 was dissipated. It is for this reason that Learned Hand J said that the rule in *Clayton's Case* was 'irrational and arbitrary', adding that '[t]o adopt it here is to apportion a common misfortune through a test which has no relation whatever to the justice of the case'.[9]

[5] (1816) 1 Mer 572; 35 ER 781. See, generally, DA McConville, 'Tracing and the Rule in *Clayton's Case*' (1963) 79 *Law Quarterly Review* 388.
[6] The model bears the latter name because it has been preferred by Canadian and United States courts: see *Caron v Jahani (No 2)* [2020] NSWCA 117 [14].
[7] [2020] NSWCA 117.
[8] C can assert equitable proprietary rights for £1,000. We leave C to one side while discussing the rule in *Clayton's Case*.
[9] *Re Walter J Schmidt & Co* 298 F 314, 316 [1] (1923), quoted in *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 35 and *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337, 376 [136]. Learned Hand J would have applied the rolling charge approach discussed below were he not bound by authority: *Re Walter J Schmidt & Co* 298 F 314, 316 [2], 320 (Supplemental Opinion) (1923).

The second difficulty is that *Clayton's Case* was not about tracing; it concerned the appropriation of payments as between banker and customer.[10] In *Re French Caledonia Travel Service Pty Ltd*,[11] Campbell J explained:

> The rule in *Clayton's Case* was a rule for appropriating payments made by a debtor in … a running account. For credit accounts, where it was the bank which was the debtor, the function of the rule in *Clayton's Case* was to decide which of the loans made by the customer to the bank was repaid when the bank met a cheque or draft. For overdraft accounts, where it was the customer who was the debtor, the function of the rule in *Clayton's Case* was to decide which of the loans which the bank had made to the customer was repaid by a deposit into the account.

In addition to being premised on a historical view of bank accounts which is no longer accepted,[12] there is no reason for the rule automatically to apply to cases involving mixed funds. In cases where multiple innocent claimants have contributed to a mixed fund, the effect is that the rights originally held on trust for those claimants have each been used to acquire a single debt[13] against the bank. The only question is to *which* rights the money subsequently withdrawn should be attributed. It makes little sense to apply in this context a rule developed in a completely different context.[14]

Despite these difficulties, the rule in *Clayton's Case* is 'probably still the default rule'[15] in English law. The leading case is *Barlow Clowes International Ltd (in liq) v Vaughan*,[16] in which the Court of Appeal held that it was not open as a matter of authority for it to reject the rule in *Clayton's Case* as applying to cases involving mixed funds and multiple innocent claimants.[17] Notwithstanding this, all three of their Lordships held the rule inapplicable on the facts.[18] Woolf LJ said that it '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'.[19]

The result has been that the rule in *Clayton's Case* 'may be displaced with relative ease in favour of a solution which produces a fairer result.'[20] Thus English courts refuse to apply the rule because: (i) it would be inappropriate in cases of large-scale fraud;[21] (ii) it would be too expensive, impracticable, or difficult to apply;[22] (iii) it would be contrary to the presumed or actual intentions of the claimants;[23] or (iv) it would be

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10 A point made in *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 28 (Dillon LJ), 36 (Woolf LJ); *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361, 368 [20]. See also Lionel Smith, *The Law of Tracing* (Clarendon Press 1997) 185–188; Aruna Nair, *Claims to Traceable Proceeds: Law, Equity, and the Control of Assets* (Oxford University Press 2018) 161–164 [5.03]–[5.08].
11 (2003) 59 NSWLR 361, 372 [31].
12 See discussion of this view in *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110, 116, 120–121, 122; Lionel Smith, *The Law of Tracing* (Clarendon Press, 1997) 188–189. The modern understanding of a bank account is that it does not involve a series of debts. It is arguable that Sir William Grant MR recognised this in *Clayton's Case* itself: see *Devaynes v Noble* (*Clayton's Case*) (1816) 1 Mer 572, 608; 35 ER 781, 793, and Aruna Nair, *Claims to Traceable Proceeds: Law, Equity, and the Control of Assets*, (Oxford University Press 2018) 162–163 [5.06]; but cf *Devaynes v Noble* (*Clayton's Case*) (1816) 1 Mer 572, 610; 35 ER 781, 793.
13 *Foskett v McKeown* [2001] 1 AC 102, 128; *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361, 380 [61]; Tatiana Cutts, 'Dummy Asset Tracing' (2019) 135 *Law Quarterly Review* 140, 148; Aruna Nair, *Claims to Traceable Proceeds: Law, Equity, and the Control of Assets* (Oxford University Press 2018) 162–163 [5.06].
14 See *Re Walter J Schmidt & Co* 298 F 314, 316 [1] (1923), quoted in *Caron v Jahani (No 2)* [2020] NSWCA 117 [83].
15 *Charity Commission for England and Wales v Framjee* [2015] 1 WLR 16, 30 [49].
16 [1992] 4 All ER 22.
17 ibid 33 (Dillon LJ), 38–39 (Woolf LJ), 44 (Leggatt LJ).
18 ibid 33 (Dillon LJ), 41–42 (Woolf LJ), 45–46 (Leggatt LJ).
19 ibid 39.
20 *Charity Commission for England and Wales v Framjee* [2015] 1 WLR 16, 30 [49].
21 *El Ajou v Dollar Land Holdings plc (No 2)* [1995] 2 All ER 213, 222.
22 *Re Eastern Capital Futures Ltd (in liq)* [1989] BCLC 371; *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 44; *Commerzbank Aktiengesellschaft v IMB Morgan plc* [2005] 2 All ER (Comm) 564, 575 [50]; *National Crime Agency v Robb* [2015] Ch 520, 536 [65].
23 *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 45.

'unjust'.[24] As Lindsay J observed *Russell-Cooke Trust Co v Prentis*,[25] 'in terms of its actual application … it might be more accurate to refer to the exception that is, rather than the rule in, *Clayton's Case*'.

In contrast, Australian courts have rejected the rule in *Clayton's Case* in this context.[26] They have done so on the bases outlined above: (i) that the rule is unjust, irrational, and arbitrary;[27] and (ii) that *Clayton's Case* itself was about the appropriation of payments as between banker and customer and had nothing to do with tracing.[28]

(2) The simple pari passu approach

The second and third solutions are two versions of what can be called the 'pari passu' approach. In England and Wales, where the rule in *Clayton's Case* rarely applies, and in Australia, where it never applies, the general rule is that in cases involving mixing as between multiple innocent claimants gains and losses are borne rateably, or pari passu.[29] The reason for this is that each claimant is innocent and because of this, no claimant's claim can be subordinated to another.[30] But this general statement masks two versions of the pari passu approach.[31] The first approach is the simple pari passu approach; the second is the rolling charge approach. As will become clear, the essential difference between the two is the point in time at which the pari passu shares are calculated.

The second solution, the simple pari passu approach, involves dividing the funds remaining in proportion to the claimants' initial contributions.[32] Any deposits and withdrawals between the date of the contribution and the date that a remedy is sought are ignored. In *Barlow Clowes*, Woolf LJ explained:

> [It] involves establishing the total quantum of the assets available and sharing them on a proportionate basis among all the investors who could be said to have contributed to the acquisition of those assets, ignoring the dates on which they made their investment.[33]

Applying the simple pari passu approach to our example above, each of Trusts A, B, and C contributed £1,000, or one third. Accordingly, the £1,800 remaining in the account is divided equally among the three trusts, so that A, B, and C can assert equitable proprietary rights in relation to £600 each.

A disadvantage of the simple pari passu approach is that it sometimes results in claimants with later contributions, which have not been depleted by subsequent withdrawals, subsidising claimants with earlier contributions, which have been depleted by subsequent withdrawals.[34] In our example above, following the contribution of £1,000 from Trust C the only dissipation was that of £200; the £1,000 dissipation occurred

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[24] *Commerzbank Aktiengesellschaft v IMB Morgan plc* [2005] 2 All ER (Comm) 564, 575 [50].
[25] [2003] 2 All ER 478, 495 [55].
[26] See *Australian Securities & Investments Commission v Enterprise Solutions 2000 Pty Ltd* [2001] QSC 82 [21]; *ASIC v Edwards* [2009] QSC 360 [14]; *Re Secured Mortgage Management Ltd* [2017] QSC 254 [23]–[25]; *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337, 376–377 [136]–[139]; *Re Global Finance Group Pty Ltd (In liq)* (2002) 26 WAR 385, 409 [112]; *Hannan v Zindilis* (2016) 51 VR 178 [25]; *Keefe v Law Society of New South Wales* (1998) 44 NSWLR 451, 460–461; *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361, 416–417 [169]; *Caron v Jahani (No 2)* [2020] NSWCA 117 [81].
[27] *Caron v Jahani (No 2)* [2020] NSWCA 117 [83].
[28] *Hagan v Waterhouse (No 2)* (1991) 34 NSWLR 308, 358; *Keefe v Law Society (NSW)* (1998) 44 NSWLR 451, 461; *Caron v Jahani (No 2)* [2020] NSWCA 117 [82].
[29] *Sinclair v Brougham* [1914] AC 398, 442; *Re Diplock* [1948] 1 Ch 465, 524, 533–534, 539; *Foskett v McKeown* [2001] 1 AC 102, 132.
[30] *Foskett v McKeown* [2001] 1 AC 102, 132.
[31] See, eg, Law Reform Commission of British Columbia, *Report on Competing Rights to Mingled Property: Tracing and the Rule in Clayton's Case* (Report No 66, September 1983) 53–54.
[32] The simple pari passu approach was famously applied by Astbury J in *In re British Red Cross Balkan Fund; British Red Cross Society v Johnson* [1914] 2 Ch 419.
[33] *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 36. See also *Caron v Jahani (No 2)* [2020] NSWCA 117 [12].
[34] *Caron v Jahani (No 2)* [2020] NSWCA 117 [13], [93], [98]–[99]; *Law Society of Upper Canada v Toronto Dominion Bank* (1998) 169 DLR (4th) 353 [51]; *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 32; *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337, 372 [120].

before the contribution from Trust C. Despite that, C is limited to asserting a lien or a trust for £600—a loss of £400 instead of a maximum loss of £200.

On the other hand, the principal advantage of the simple pari passu approach is exactly that: it is simple.[35] Some have therefore sought to justify it on the basis that it is convenient, workable, and inexpensive to apply.[36] But Lionel Smith has criticised this justification, asking: '[i]s it really a principle of private law that parties' rights may be forfeited to convenience? And if so, whose convenience?'[37] And as Lord Atkin once said, '[c]onvenience and justice are often not on speaking terms'.[38]

(3) The rolling charge approach

The third solution, the rolling charge approach, is a refinement of the simple pari passu approach.[39] To quote Woolf LJ in *Barlow Clowes* once again:

> The solution involves treating credits to a bank account made at different times and from different sources as a blend or cocktail with the result that when a withdrawal is made from the account it is treated as a withdrawal in the same proportions as the different interests in the account ... bear to each other at the moment before the withdrawal is made.[40]

While both the simple pari passu approach and the rolling charge approach calculate the interests of the claimants on a pro rata basis, the key difference is that the rolling charge approach recalculates those interests after each transaction,[41] taking into account the lowest intermediate balance rule: the rule that, 'absent any payment in of money with the intention of making good earlier depredations, tracing cannot occur through a mixed account for any larger sum than is the lowest balance in the account between the time the beneficiary's money goes in, and the time the remedy is sought'.[42]

In our example above, at the time the £1,000 is dissipated, Trusts A and B have both contributed £1,000 to the mixed fund. After the dissipation A and B therefore have a proportionate share of one half each. When the £1,000 from Trust C is deposited, the proportionate shares of the claimants become one quarter (A), one quarter (B), and one half (C). Finally, when the second withdrawal of £200 is made, reducing the balance to £1,800, the proportions remain the same, with the result that the claimants can trace into £450, £450, and £900 respectively.

Compare this outcome with the result when the simple pari passu approach was applied: C (the later contributor) was forced to subsidise A and B (the earlier contributors). On the rolling charge approach, the loss of the £1,000 is borne rateably by A and B (and not C), who had paid money into the fund before the

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[35] *Caron v Jahani (No 2)* [2020] NSWCA 117 [13]; *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 36; *Law Society of Upper Canada v Toronto Dominion Bank* (1998) 169 DLR (4th) 353 [34], [37].
[36] *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 36; *Law Society of Upper Canada v Toronto Dominion Bank* (1998) 169 DLR (4th) 353 [37]; *Charity Commission for England and Wales v Framjee* [2015] 1 WLR 16, 30 [48].
[37] Lionel Smith, 'Tracing in Bank Accounts: The Lowest Intermediate Balance Rule on Trial' (2000) 33 *Canadian Business Law Journal* 75, 88, quoted with apparent approval in *Caron v Jahani (No 2)* [2020] NSWCA 117 [98].
[38] *General Medical Council v Spackman* [1943] AC 627, 638.
[39] See *Caron v Jahani (No 2)* [2020] NSWCA 117 [11], [84], [109].
[40] *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 35. See also 27–28, and see further *Caron v Jahani (No 2)* [2020] NSWCA 117 [14], [108]; *Hannan v Zindilis* (2016) 51 VR 178 [27]; *Charity Commission for England and Wales v Framjee* [2015] 1 WLR 16, 30 [48]; *Australian Securities and Investments Commission v Letten (No 7)* [2010] FCA 1231 [280].
[41] *Pars Ram Brothers (Pte) Ltd v Australian & New Zealand Banking Group Ltd* [2018] 4 SLR 1404 [15].
[42] *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361, 417–418 [175]. See *James Roscoe (Bolton) Ltd v Winder* [1915] 1 Ch 62, 69; *Bishopsgate Investment Management Ltd (in liq) v Homan* [1995] Ch 211, 219; *Federal Republic of Brazil v Durant International Corporation* [2016] AC 297, 305 [11].

dissipation. The loss of the £200, which occurs after A, B, and C have all contributed to the fund, is borne rateably by all three.

Our example illustrates the primary advantage of the rolling charge approach over the simple pari passu approach: it is fairer and more principled.[43] The primary disadvantage of the rolling charge approach, however, is that it is costly and complicated to apply in full in large matters.[44]

THE AUTHORITIES BEFORE *CARON*

We noted above that the rule in *Clayton's Case* (the first solution) has been discarded in Australia and discarded in all but name in England and Wales. But which version of the pari passu approach (the second and third solutions) is applied? On the whole, until the decision in *Caron*, the simple pari passu approach was adopted instead of the rolling charge approach.[45] This continues to be the position in English courts,[46] where the rolling charge approach has 'been considered in a number of English authorities, but never yet applied in practice'.[47] The primary reason for this seems to be the disadvantage noted above: the cost and complexity involved.[48]

Elsewhere in the law of tracing, both English and Australian courts clearly accept the lowest intermediate balance rule. But there is a clear tension between the acceptance of that rule and the preference expressed in the authorities for the simple pari passu approach. The tension arises because the simple pari passu approach does not take account of the fact that because of withdrawals between the date of the contribution and the date on which a remedy is sought, a claimant's initial contribution may no longer be reflected in the fund in whole or in part. But that fact—that the final credit balance of the account may not be attributable to all the rights that were used to acquire it—is precisely what the lowest intermediate balance rule requires courts to take into account.[49]

Expressed another way, the rolling charge approach is nothing more than a version of the lowest intermediate balance rule.[50] There is therefore a tension between the acceptance of the lowest intermediate balance rule and the simultaneous rejection of the rolling charge approach. In Australian law, this tension finally came to a head in *Caron*.

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[43] *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 27–28, 35; *Law Society of Upper Canada v Toronto Dominion Bank* (1998) 169 DLR (4th) 353 [32], [51]; *Caron v Jahani (No 2)* [2020] NSWCA 117 [15], [115], [117]; *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361 [177]–[178].

[44] *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 28, 35; *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337 [141]; *Re Global Finance Group Pty Ltd* (2002) 26 WAR 385 [229]; *Law Society of Upper Canada v Toronto Dominion Bank* (1998) 169 DLR (4th) 353 [24], [32], [39]–[40]; *Caron v Jahani (No 2)* [2020] NSWCA 117 [16], [106], [120]–[121].

[45] See, eg, *Keefe v Law Society of New South Wales* (1998) 44 NSWLR 451, 460–461; *Australian Securities and Investments Commission v Nelson* [2003] NSWSC 129; *Australian Securities and Investments Commission v Enterprise Solutions 2000 Pty Ltd* [2001] QSC 82; *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361.

[46] See *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22; *Charity Commission for England and Wales v Framjee* [2015] 1 WLR 16, 34 [63]–[64].

[47] *Charity Commission for England and Wales v Framjee* [2015] 1 WLR 16, 30 [48].

[48] *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 28, 35; *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337, 378 [141]; *Re Global Finance Group Pty Ltd* (2002) 26 WAR 385, 430–431 [229]. See also *Australian Securities and Investments Commission v Letten (No 7)* [2010] FCA 1231 [280]; *Hannan v Zindilis* (2016) 51 VR 178 [27].

[49] See *Caron v Jahani (No 2)* [2020] NSWCA 117 [107].

[50] *Law Society of Upper Canada v Toronto-Dominion Bank* (1998) 169 DLR (4th) 353 [25]; *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337, 378 [141]; *Hannan v Zindilis* (2016) 51 VR 178 [27]. Indeed, in *Caron v Jahani (No 2)* [2020] NSWCA 117, Bell P seemed to refer to the two interchangeably.

CARON V JAHANI (NO 2)

Facts

Caron concerned the aftermath of a Ponzi scheme perpetrated by two companies (referred to together as 'Courtenay House') and an application by the liquidators of those companies for directions as to the distribution of limited amounts held in the companies' bank accounts.

Courtenay House received funds from investors who were seeking to engage in foreign exchange trading. The products Courtenay House purported to offer were marketed as leveraging off the volatility in the financial markets caused by the United States Presidential election and Brexit. In fact, little foreign exchange trading was conducted. Instead, Courtenay House used deposits from new investors to provide 'returns' to earlier investors. Between $213 million and $248 million was deposited by investors into the companies' bank accounts over the lifetime of the scheme. The appeal, however, was concerned with one particular bank account, which had received approximately $185 million in deposits, but had only a balance of $21 million by the time liquidators were appointed.

On 21 April 2017, freezing orders were obtained over Courtenay House's assets. But on the same day there were a number of deposits into the account by investors and a withdrawal of $60,000. Moreover, there were further deposits into the account by investors for another five days. The final balance in the account was insufficient to meet the claims of all the investors.

The primary contest was between two groups of investors: (i) the investors who had deposited funds before the freezing order ('pre-order investors'); and (ii) investors who had deposited funds on or after the day the freezing order came into effect ('post-order investors'). The post-order investors were further divided into two groups: (i) those who deposited funds after the freezing order came into effect but on the same day as the $60,000 withdrawal; and (ii) those who deposited funds after the $60,000 withdrawal.

Decision

The issue for the Court was how the funds in the account should be distributed in insolvency. It was held at first instance, and assumed on appeal, that the investors' funds were held either on an express trust, a *Quistclose* trust,[51] or a *Black v S Freedman & Co Ltd*[52] constructive trust.[53] The respondent, who represented the pre-order investors, argued that the simple pari passu approach should apply. The appellants, who represented the post-order investors, argued instead that a version of the rolling charge approach should apply such that the post-order investors who deposited funds on 21 April 2017 could recover their investments less a pro-rata share (with the pre-order investors) of the $60,000 withdrawal made on the same day, and the post-order investors who deposited funds after the $60,000 withdrawal could recover their investments in full.[54]

[51] *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567.
[52] (1910) 12 CLR 105.
[53] *Caron v Jahani (No 2)* [2020] NSWCA 117 [2] (Bathurst CJ), [48] (Bell P).
[54] Less costs and subject to the principles of hotchpot: see ibid [55]–[58].

The primary judge (Black J) applied the simple pari passu approach. The Court of Appeal (Bell P, with whom Bathurst CJ and Macfarlan JA agreed) allowed the appeal, holding that the lowest intermediate balance rule or rolling charge approach (which were referred to interchangeably) should be applied.

In a scholarly judgment, Bell P discussed the 'three alternative approaches to the conundrum as to how to distribute limited funds of investors in a mixed, blended or co-mingled account'.[55] His Honour noted that the rule in *Clayton's Case* had not been applied in Australia.[56] The primary contest was therefore between the simple pari passu approach and the rolling charge approach.

Ultimately, his Honour preferred the rolling charge approach, noting that the 'application of the lowest intermediate balance rule best accords with both authority and long established rules of tracing'.[57] His Honour also noted that 'the simple *pari passu* approach is not necessarily to treat all investors equally, other than in a superficial sense'[58] and that if applied in this context it would 'force one victim to subsidise another … and openly to redistribute property'.[59]

In response to the English and Australian authorities which favoured the simple pari passu approach, his Honour noted that '[t]he objections to the application of the lowest intermediate balance rule rest not on principle, but in a practical concern relating to the cost and complexity of its application'.[60] But his Honour went on immediately to explain that this concern should not prevent an investor from seeking 'to follow or trace into that fund to identify an equitable proprietary interest'.[61] In particular, his Honour stated that 'relatively clear property interests are not be altered by reference to some notion of common misfortune'.[62]

The President explained that the rolling charge approach 'recognises the continuing vitality of "clearly discernible property rights" … and is a means of identifying them'.[63] His Honour added that '[w]here evidence is available … [it] provides … the fairest, most equitable and principled outcome for the allocation of limited funds between investors'.[64] Bell P continued:

> True it is that more recent investors will do better than earlier investors under this method, but that result follows from the application of established principle and respects the historical operation of the account in which funds have been co-mingled and the investors' underlying proprietary interests. This quintessentially factual approach is superior to the fiction or presumption upon which the so-called rule in *Clayton's Case* rests, and is also superior to the simple *pari passu* approach because, whilst incorporating a modified form of rateability, it is more consistent with equitable principle and the rules of tracing…[65]

His Honour also drew a distinction between the position a court might take (i) when faced with an application for directions by a liquidator, and (ii) when faced with an individual claimant seeking to assert rights in relation to a mixed fund. As his Honour explained, liquidators 'have to act on such evidence as is available, together with reasonably available inferences, without insisting on the proofs that would be

[55] ibid [77].
[56] ibid [78]–[83].
[57] ibid [164].
[58] ibid [164].
[59] ibid [165].
[60] ibid [120]. See also [122].
[61] ibid [123].
[62] ibid [124].
[63] ibid [145].
[64] ibid [146].
[65] ibid [147].

required in a beneficiary's claim'.[66] A liquidator might, in certain circumstances, conclude that it would be 'impractical or excessively and counter-productively costly' to apply the rolling charge approach.[67] The liquidator can then seek directions that he or she would be 'justified' in distributing the mixed fund according to the simple pari passu approach, and the directions given would operate to immunise the liquidator from personal liability for taking that course.[68] But importantly, Bell P explained that in such cases, 'the Court is not determining equitable proprietary rights'.[69]

On the other hand, if an individual claimant insists on asserting equitable proprietary rights by tracing into a mixed fund, he or she may do so, even though the liquidator has otherwise sought the court's blessing to distribute the mixed fund according to the simple pari passu approach.[70] But that beneficiary must (unlike the liquidator) establish the proprietary interest claimed on the balance of probabilities.[71] That is, it is an exercise in establishing proprietary rights.[72] Although this course is open to any beneficiary, his Honour went on to note that:

> [It] will generally be easier for those depositors or investors who have made their investments at a later point in time, because such deposits will either not have been eroded by withdrawals, or only rateably diminished by a smaller number of withdrawals than will be the case for earlier depositors.[73]

This distinction, however, should not be taken as suggesting that a court will always order a pari passu distribution on an application for directions as to the distribution of limited funds in a bank account. Rather, Bell P summarised the general approach to an application for such directions in this way:

> '[W]here there can be tracing, there shall be tracing. Where there cannot, the "nearest approach practicable to substantial justice" shall be taken.' This translates, in my view, to adoption of the lowest intermediate balance rule which is … 'pro rata sharing on the basis of tracing' … with application of the simple *pari passu* approach to be undertaken if application of the lowest intermediate balance rule is not feasible or possible … [I]n this context, the language 'not possible' or 'impossible' does not mean impossible in any absolute sense, but rather not economically or reasonably practical …[74]

Applying these statements of principle to the present case, his Honour held that the liquidators were justified in determining the amounts to be distributed to the post-order investors on the basis that:

(i) those post-order investors who had made deposits on the day of the freezing order and the $60,000 withdrawal were entitled to the amount of their deposit less the pro rata share (with the pre-order investors) of the $60,000 withdrawal[75] and costs; and

(ii) those post-order investors who had made deposits after the day of the freezing order and the $60,000 withdrawal were entitled to the full amount of their deposit less costs.

[66] ibid [150].
[67] ibid [154].
[68] ibid [151]–[152].
[69] ibid [151].
[70] ibid [152].
[71] ibid.
[72] ibid.
[73] ibid [153].
[74] ibid [133].
[75] On the basis that none of these investors could demonstrate that the withdrawal occurred prior to the deposit on the same day: ibid [178]–[179].

A Simplified Rolling Charge Approach?

A particularly noteworthy feature of *Caron* is that it involved a *partial* application of the rolling charge method. The rolling charge method was not applied to each transaction, only to the last withdrawal of \$60,000. This simplified version of the rolling charge approach avoids many of the objections which have been raised to the rolling charge approach more generally.

Given the paucity of direct authority on the point, it is surprising that Bell P did not discuss the decision of Henderson J in *Charity Commission for England and Wales v Framjee*.[76] In that case, the Charity Commission sought declarations concerning the distribution of moneys paid by members of the public to a charity, the 'Dove Trust'. The Dove Trust ran a website through which it received donations in support of various charitable activities. But the website was poorly administered, with the result that the Dove Trust 'found itself obliged to have recourse to incoming donations in a later month in order to fund the payment to ultimate recipients of donations made in a previous month'—a process described by Henderson J as having a 'generic similarity to the typical method of operation of a pyramid or Ponzi scheme'.[77]

On 6 June 2013, the Commission appointed Mr Framjee as an interim manager of the Dove Trust. On 28 June 2013, the Commission also made an order freezing the Dove Trust's numerous bank accounts. All payments out of the accounts (distributions to nominated recipients) had been made either on or just before 6 June 2013 and no further distributions were made after that date. However, because the Commission had not made any public announcement of Mr Framjee's appointment, further donations of some £466,000 from the public were made until 12 July 2013 when Mr Framjee shut down the website. The amount standing to the credit of the trust's various bank accounts (which were treated as a single mixed fund for this purpose) was £709,529.

No party submitted that the rule in *Clayton's Case* should be applied. However, counsel for Mr Framjee argued that instead of the simple pari passu approach, a 'simplified version of the rolling charge approach'[78] should be applied. The proposal was that:

> [T]he available funds should be divided into two pools, one constituting the sum available for distribution after the final run of payments on 5 or 6 June 2013, and the other constituting all donations received after that date. Each pool, it is submitted, should then be distributed pari passu among those entitled to share in it.[79]

Despite confessing an 'initial attraction to the two pool approach',[80] Henderson J ultimately concluded that 'it should be rejected in favour of a single pari passu distribution of the entire fund'.[81] His Lordship thought that there was 'no room for a half-way house which applies the rolling charge method on a selective basis'.[82] His Lordship said:

> I think the fairest solution is to regard all the unpaid recipients as participants in a common misfortune brought about by the way in which the donation scheme was managed by the trustees … There is admittedly an element of rough justice involved for the most recent contributors to the pool, but this seems to be unavoidable once

[76] [2015] 1 WLR 16. It was cited once in Bell P's judgment, referring to an observation by Henderson J about the cost and expense of the rolling charge method, but the case itself was not discussed: ibid [121].
[77] *Charity Commission for England and Wales v Framjee* [2015] 1 WLR 16, 20 [10].
[78] ibid 31 [50].
[79] ibid 32 [55].
[80] ibid 33 [60].
[81] ibid.
[82] ibid 34 [63].

a decision has been taken in favour of pari passu distribution, which itself responds to a very basic human feeling that, when faced by a common misfortune, all those affected by it should bear the burden equally.[83]

Although Bell P did not consider this decision, his Honour's judgment in *Caron* is a strong rebuke to such reasoning. In particular, as we noted above, his Honour was adamant that 'relatively clear property interests are not be altered by reference to some notion of common misfortune'.[84] Indeed, the effect of approaches such as that taken in *Framjee* is to render clearly established equitable proprietary rights illusory and 'openly to redistribute property'.[85]

FUTURE DEVELOPMENTS IN ENGLISH LAW?

Caron presents an opportunity for English courts to revisit their approach to the problem of how a limited fund is to be distributed among multiple innocent claimants. If English courts seize that opportunity, we respectfully suggest that they would be justified in developing the existing law in two ways.

First, it is time that English courts jettison the rule in *Clayton's Case* from the law of tracing once and for all. As we explained above, the case had nothing at all to do with tracing, and the rule to which it has given its name is irrational, unjust, and arbitrary. These concerns are not new: in *Barlow Clowes*,[86] all three of their Lordships recognised that *Clayton's Case* said nothing about tracing,[87] and at least two described the rule's consequences as 'capricious'.[88] The only reason the Court of Appeal did not rid English law of the rule was that it felt constrained by authority.[89]

Worse still, modern English courts barely pay the rule lip service: they cite it only to refuse to apply it. The preferable approach, as *Caron* shows, is to not apply *Clayton's Case* at all. English law already rejected the rule in *Clayton's Case* as a method of determining a claimant's equitable proprietary rights in cases of trust money being mixed with a trustee's own money as long ago as *Re Hallett's Estate*.[90] The issue is ripe for re-examination by the Supreme Court, which should follow the lead of Australian,[91] New Zealand,[92] Canadian,[93] and Singaporean[94] law, and hold that the rule in *Clayton's Case* simply is not applicable in *any* case involving tracing and mixed funds.

Secondly, contrary to the approach taken in cases like *Framjee*, English law should, where possible, give effect to the lowest intermediate balance rule by applying the rolling charge approach, even if only in part—this is the 'simplified rolling charge approach'. In fact, this is nothing new. In *Sinclair v Brougham*,[95] the House of Lords ordered that the liquidator distribute the assets of the building society according to the simple pari passu approach, 'subject to any application which may be made by any [claimant], with a view of tracing

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[83] ibid 33–34 [61].
[84] *Caron v Jahani (No 2)* [2020] NSWCA 117 [124].
[85] ibid [165]. Andrew Kull has criticised the similar fate which has befallen American courts whereby established tracing rules are disregarded in the court's exercise of discretion, with the result that 'a court exercising its equity powers is constrained only by its sense of justice in allocating ownership of disputed assets between competing claimants': Andrew Kull, 'Ponzi, Property, and Luck' (2014) 100 *Iowa Law Review* 291, 300.
[86] [1992] 4 All ER 22.
[87] *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 28 (Dillon LJ), 36 (Woolf LJ), 44 (Leggatt LJ).
[88] ibid 35 (Woolf LJ), 46 (Leggatt LJ).
[89] ibid 33 (Dillon LJ), 38-39 (Woolf LJ), 44 (Leggatt LJ).
[90] (1880) 13 Ch D 696; overruling *Pennell v Deffell* (1853) 4 De G M & G 372; 43 ER 551.
[91] *Caron v Jahani (No 2)* [2020] NSWCA 117.
[92] *Re Registered Securities Ltd* [1991] 1 NZLR 545.
[93] *Re Ontario Securities Commission and Greymac Credit Corp* (1986) 30 DLR (4th) 1 (Ont CA); appeal dismissed (1988) 52 DLR (4th) 767 (Sup Ct).
[94] *Pars Ram Brothers (Pte) Ltd v Australian & New Zealand Banking Group Ltd* [2018] 4 SLR 1404, albeit this case was concerned with physical mixtures of pepper which were subsequently sold by the liquidators of the company. Cf *Re Diplock* [1948] Ch 465, 555, where the Court of Appeal refused to extend the rule in *Clayton's Case* beyond the case of a bank account.
[95] [1914] AC 398.

his own money into any particular asset'.[96] The idea was also discussed in *Barlow Clowes*.[97] Woolf LJ accepted that if it could be shown that a claimant's contribution had not been depleted by subsequent withdrawals, 'special consideration' would be required.[98] But he rejected a submission that 'the position must be, proportionately, the same' where it could be shown that the contribution had only been partially depleted.[99]

Caron shows that Woolf LJ's conclusion in *Barlow Clowes*, and the approach of Henderson J in *Framjee*, is flawed and should not be followed by English courts. Exceptional cases aside,[100] the simplified rolling charge approach should be the default approach. Applying that approach will produce a more principled result than the simple pari passu approach in at least two situations:

(i) where the interests of later contributors can be clearly established, such as where deposits have been made after the last withdrawal from the account—in such cases, the later contributors should be able to recover their contributions in full; and

(ii) where the account was at any point in time overdrawn—in such cases, the lowest intermediate balance rule should be applied to preclude those who contributed funds prior to the account becoming overdrawn from tracing into later deposits by other contributors.[101]

While this is a change of emphasis from the weight of previous authority, we have seen above that it is not without precedent.[102] Moreover, it is a change of emphasis which should be welcomed.

CONCLUSION

The insight of *Caron* is that once the rule in *Clayton's Case* is discarded, what remains is not simply a binary choice between (i) applying the rolling charge method in full, analysing every transaction in the bank account at great cost and expense, and (ii) dividing the fund equally between all claimants, ignoring the factual realities of what has occurred.[103] Where a claimant can establish his or her equitable proprietary rights by reference to the tracing rules or where the proprietary rights of a claimant or group of claimants are otherwise clear, the simplified rolling charge approach should be applied. It is only where this is not the case that the liquidator should—after obtaining the necessary directions from the court—distribute the fund according to the simple pari passu approach. That is the 'nearest approach practicable to substantial justice'.[104]

[96] *Sinclair v Brougham* [1914] AC 398, 460. See also 424, 427 (Viscount Haldane LC, with whom Lord Atkinson agreed). Bell P also noted this in *Caron v Jahani (No 2)* [2020] NSWCA 117 [132].
[97] [1992] 4 All ER 22, 32 (Dillon LJ), 41–42 (Woolf LJ).
[98] ibid 41–42.
[99] ibid 42. Bell P discussed this in *Caron v Jahani (No 2)* [2020] NSWCA 117 [125]–[126].
[100] We are not concerned with those cases. One example is where 'records are not available so that it is impossible to identify the money belonging to each person who has contributed to a common or mixed fund': *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337, 373 [123]. See also *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361, 420 [186].
[101] The effect is to treat the two groups of contributors (before and after the overdrawn balance) as separate classes, with the result that the money in the account at the date a remedy is sought represents only the money of the latter class, and not the class of contributors who contributed funds before the account was overdrawn: see *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361, 420–421 [187]–[189].
[102] See the text accompanying footnotes 96 and 97. See also *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361, 420–421 [187]–[189].
[103] See also *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361, 421 [192].
[104] *Caron v Jahani (No 2)* [2020] NSWCA 117 [133], citing *McKenzie v Alexander Associates Ltd (No 2)* (1991) 5 NZCLC 67,046, 67,065, but the quote originates from *Sinclair v Brougham* [1914] AC 393, 424.