View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by CURVE/open

Coventry
University

Coventry University Repository for the Virtual Environment (CURVE)

Author name: Panesar, S.
Title: Collective investment schemes, breach of trust and distribution of funds.
Article & version: Published version
Original citation & hyperlink:
Panesar, S. (2004) Collective investment schemes, breach of trust and distribution of funds. *International Company and Commercial Law Review*, volume 14 (9): 289-292
http://www.sweetandmaxwell.co.uk/Catalogue/ProductDetails.aspx?recordid=423&productid=6944

Published by Sweet & Maxwell.

Copyright © and Moral Rights are retained by the author(s) and/ or other copyright owners. A copy can be downloaded for personal non-commercial research or study, without prior permission or charge. This item cannot be reproduced or quoted extensively from without first obtaining permission in writing from the copyright holder(s). The content must not be changed in any way or sold commercially in any format or medium without the formal permission of the copyright holders.

Available in the CURVE Research Collection: March 2012

http://curve.coventry.ac.uk/open

International Company and Commercial Law Review

2003

Editorial

Collective investment schemes, breach of trust and distribution of funds

Sukhninder Panesar

Subject: Banking and finance. **Other related subjects:** Legal profession. Trusts

Keywords: Bank accounts; Breach of trust; Client accounts; Collective investment schemes; Distribution; Solicitors

Cases: Russell-Cooke Trust Co v Prentis (No.1) [2002] EWHC 2227 (Ch); [2003] 2 All E.R. 478 (Ch D)

Clayton's Case (1816) 1 Mer. 572

I.C.C.L.R. 289 Introduction

Where a collective investment scheme ceases to operate with a substantial shortfall in funds owing to the beneficiaries under the scheme, the question arises as to how that fund should be distributed. There are a number of possible ways in which the distribution can be made. First, the most obvious solution is for the funds to be distributed to the beneficiaries *pari passu* to the respective contributions made by the beneficiaries. Secondly, given the fact that the funds would have been the subject to mixing in a bank account, the so-called rule in *Clayton's Case* could apply.1 This rule, often described as the "first in, first out" rule, simply lays down that the first payment into the account is presumed to be the first payment out. The remaining balance of the funds is to be distributed to those beneficiaries whose funds were paid into the account much later on and have not been exhausted. The rule is one that is not without controversy and there has been much judicial and academic debate as to its proper application in modern trust law. Finally, a solution used in North America, which is to have a rolling charge over the fund. The High Court in *Russell-Cooke Trust Co v Prentis*2 has recently had the opportunity to decide which of these three methods of distribution should be applied to the collapse of an investment scheme with funds owing to a substantial number of contributors. In doing so it has once again highlighted the inadequacies of applying the rule in *Clayton's Case* in the modern law.

The facts

The facts concerned an investment scheme run by a solicitor, which in June 2000 ceased to operate as a result of intervention by the Law Society, with substantial shortfalls in the funds owed to the contributors. Custodian trustees were appointed and the question was how should the remaining funds be distributed amongst the contributors under the scheme? The investment scheme was called the "Secured Property Investment Plan" (the SPIP) and worked on the following premises. The plan offered investors a fixed rate 15 per cent per annum return on sums invested. Monies received by the solicitor were paid into the solicitor client account called the "Prentis no.2 client account".3 The money (belonging to more than one investor) was then to be loaned to a borrower by way of a charge over his property at an interest rate of 15 per cent per annum. Save in one case, the investors were not consulted on matters relating to the type of property over which the loans were being made by the solicitor operating the scheme. As and when interest had become due it was paid into the "Prentis no.3 client account", which was intended as the account to be used to pay the investors the sums due to them under the plan.

The plan attracted some £6 million by way of investment. However, subsequently a number of irregularities had been found in the conduct of the operation of the SPIP. There was no co-relation between interest received or deducted in advance from a particular borrower ***I.C.C.L.R. 290*** and interest paid to an investor or investors to whom a charge

from that borrower had been allocated. Neither Mr Prentis nor his firm kept a cashbook for any of the relevant bank accounts or a complete list of investors. There were substantial shortfalls in both income and capital to meet the claims of individual investors. It was established there was a shortfall of some £3.66 million in the fund needed to meet the claims of the investors. On June 2, 2000 the Law Society intervened and Mr Prentis was struck off the roll of solicitors of the Supreme Court. The consequence of this was that Mr Prentis and his firm were incapacitated from acting as trustees in relation to trusts conducted by them. By instructions of the Court, Russell-Cooke Trust Co, a custodian trustee, was appointed to control the assets of the SPIP scheme.

The legal issues in relation to SPIP

There were three main legal issues for the court to resolve in *Russell-Cooke Trust Co v Prentis.* First, how many invested schemes did the SPIP create? Secondly, were any of these investment schemes "collective investment schemes" within the meaning of s.75 of the Financial Services Act?4 Finally, who were the beneficial owners of the Prentis no.2 client account? It is the last of these three questions which is of most relevance in this article. However, the Court did resolve the other questions in the following manner. In response to the first question, Lindsay J. held that it would be inappropriate to talk of "investment schemes" especially when no real definition had been given to that term in the SPIP. The Judge proceeded to answer the question by reference to the question of what trusts the assets of SPIP (other than the non-invested no.2 account funds) were held under. In doing so Lindsay J. identified three possible outcomes. First, that all of the assets belonged to one common pool and that all the investors would be entitled on the basis of respective contributions. Secondly, that the trustee company held a series of separate trusts for each contributor who could be identified with a specific security. Finally, an "intermediate solution" where there was a combination of separate trusts as well as entitlement to a common pool. Lindsay J. held that where "specific property had been allocated as security to specific investors" then separate investment schemes or trusts had been created and belonged specifically to those investors. In so far as the remaining assets which were not linked to a specific security, Lindsay J. held that they were to be treated as belonging to the contributors as collective assets for the purposes of the Financial Services Act 1986. According to this Act and the regulations made under it, the funds would have to be distributed *pari passu,* that is rateably.5 This left the question as to how the Prentis no.2 client account was to be distributed.

The rules relating to the mixing of funds in a bank account

The traditional rule applying to the distribution of mixed funds in a bank account was laid out in *Devaynes v Noble,* otherwise known as the rule in *Clayton's Case.*6 The rule lays down that the first payment into the account is presumed to the first payment out of the account, the so called "first in, first out" rule.7 The rule is based on the presumed intentions of the person operating the account, but has been described by some commentators as "capricious and arbitrary".8 In ***I.C.C.L.R. 291** one American case Judge Learned Hand commented on the rule by saying:

"... to throw all the loss upon one, through the mere chance of his being earlier in time, is irrational and arbitrary, and is equally a fiction as the rule in Clayton's case. When the law adopts a fiction, it is, or at least it should be, for some purpose of justice. To adopt it here is to apportion a common misfortune through a test which has no relation whatever to the justice of the case."9

In other jurisdictions the rule has been rejected and restricted to appropriate situations.10

However, despite the criticisms of the rule, the Court of Appeal in *Barlow Clowes International Ltd v Vaughan*11 confirmed the rule but held that it applied subject to a contrary intention that could be express or presumed. The facts of *Barlow Clowes* concerned investments by a number of investors in schemes operated by Barlow Clowes International Ltd. The money in these schemes had been wrongfully dissipated and the question was whether the rule in *Clayton's Case* applied or whether the money was held rateably for the investors. Whilst holding that the rule in *Clayton's Case* was binding on the

Court of Appeal, Woolf L.J. held that here there was a shared misfortune and as such the intention of the investors was that the rule did not apply so that the fund should be shared rateably.12 On the other hand Dillon L.J. did not think that it would be unjust to apply the rule in *Clayton's Case.* In his view, later investors might well feel that it would be unfair for their claims to be ranked rateably with the earlier investors.13

An alternative solution to the rule in *Clayton's Case* is the rollingcharge method used in North America. This method was considered at length by the Court of Appeal in *Barlow Clowes* and operates on the following basis. Where money has been mixed in an account, the beneficiaries should share a loss in proportion to their interest in the account immediately before each withdrawal. Woolf L.J. described the rule by commenting that it was a solution whereby:

"... credits to a bank account made at different times and from different sources are treated 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 (here of the investors) bear to each other at the moment before the withdrawal is made."14

Although the rolling-charge method does appear to be a much fairer solution to the distribution of the fund, it is one that is not always practical in the case of large collective investments.

The decision in *Russell-Cooke Trust Co v Prentis*

In deciding how the Prentis no.2 client account should be distributed to the investors, Lindsay J., whilst recognising the criticisms of the rule in *Clayton's Case,* nevertheless held that the rule was binding on the court but could be distinguished by the facts of the particular case. In particular the rule could be dispensed with where there was an express or presumed counter intention that the rule was not intended to apply. In the words of Lindsay J. "the modern approach in England has generally not been to challenge the binding nature of the rule but rather to permit it to be distinguished by the reference to the facts of the particular case".15 In support of this the judge referred to the Court of Appeal's decision in *Barlow Clowes International Ltd v Vaughan*16 where the rule was not applied because it could not have been the intention of the investors that this would have been the contemplated way in which the funds would be distributed in the ***I.C.C.L.R. 292** event of the collapse of the investment scheme. Certainly a distribution which would do no justice on the facts of that case.

On the facts of *Russell-Cooke Trust v Prentis* Lindsay J. found that there was significant evidence that the rule in *Clayton's Case* was not intended to apply. In particular the facts illustrated that the payments made into the account were not always paid out in the same sequence. The allocation of money from the account was completely out of sequence with the payments made into the account. In the words of Lindsay J.:

"... whilst the brochures (given to the investors under the SPIP) made it plain that investments might be combined, nothing indicated combinations would be made up in a strict temporal sequence ... It is, as I see it, one thing to apply a 'first in, first out', rule where it might have been expected or intended by the investors to be applied and where nothing is known inconsistent with its being so expected or intended but quite another to presume it to be an intention where both a reasonable contemplation of what was intended and the known facts can be seen to be inconsistent with it."

As regards the North American rolling-charge method, the court did not feel the need to consider it, as the rule in *Clayton's Case* did not apply on the facts. The rolling charge was only an alternative means of distribution which would do more justice on the facts as compared with the "first in, first out" method. Lindsay J. did, however, comment that the rolling-charge method was in any event very complicated and expensive to apply in a situation where there were many investors and the payments into and out of the account were made without much temporal sequence.

Conclusion

Unlike some other jurisdiction, English law has yet to decide the fate of the rule in *Clayton's Case.* Whilst recognising the injustices that can arise from a system of "first in, first out", English law continues to hold good the rule yet adopts a rather different test in its application to given factual situations. The approach suggested both in the Court of Appeal's decision in *Barlow Clowes International Ltd v Vaughan*17 and in the High Court in *Russell-Cooke Trust Co v Prentis* is to distinguish the rule by particular reference to the facts of a given case. In both of these cases, where investors had pooled their investments, nothing on the facts could have suggested that the equitable solution in the distribution of the remaining funds after the collapse of the investment scheme was intended to be on the basis of a "first in, first out" method.

Whilst the decision in *Russell-Cooke Trust Co v Prentis* is a sensible and practicable one on the facts of the case, there are some who may argue whether the rule in *Clayton's Case* is simply an unnecessary point of law which has no significance in the modern law. Although the rule has not been applied to large investment schemes where it would produce an unfair and inequitable outcome in the distribution of funds remaining in a current account, the same result is achieved in a current account with a small number of investors or beneficiaries. Some commentators have argued that the decision of the Court of Appeal in *Barlow Clowes International Ltd v Vaughan*18 : "... amounted to a strong entreaty to the House of Lords to consider the rule and its continuing application in the law."19 For the meantime the rule in *Clayton's Case* remains good law, only to be quickly dispensed with when the facts do not contemplate its application.

Sukhninder Panesar

Coventry Business School

Coventry University

I.C.C.L.R. 2003, 14(9), 289-292

1.

Clayton's Case, Devaynes v Noble (1816) 1 Mer. 572; [1814-23] All E.R. Rep.1.

2.

[2003] 2 All E.R. 478.

3.

As required under the Financial Services (Client Money) Regulations 1991.

4.

See now s.235 Financial Services and Markets Act 2000.

5.

The Financial Services (Client Money) Regulations 1991.

6.

(1816) 1 Mer. 572; 35 E.R. 781; [1814-23] All E.R. Rep.1.

7.

The rule is firmly embodied in the law of trusts where it is analysed alongside the rules of tracing. In one leading authority on the law of tracing the rule was confirmed as the appropriate means of tracing funds into a mixed account: see *Re Hallett's Estate* (1880) 13 Ch. D. 696.

8.

Goff and Jones, *The Law of Restitution* (5th ed., 1998), p.108.

9.

Re Walter J Schmidt & Co Ex p. Feuerbach (1923) 298 F. 314 at 316.

10.

Re Registered Securities Ltd [1991] N.Z.L.R 545 (New Zealand approach). In this case the Court of Appeal in New Zealand refused to apply the rule in *Clayton's Case* where it was not

possible to trace investors' money into mortgages allocated to them. Instead a *pari passu* method was employed to achieve a result which would be do more justice on the facts.

11.

[1992] 4 All E.R. 22.

12.

ibid. at 42.

13.

ibid. at 32.

14.

ibid. at 35.

15.

[2003] 2 All E.R. 478 at 984.

16.

[1992] 4 All E.R. 22.

17.

[1992] 4 All E.R. 22.

18.

[1992] 4 All E.R. 22.

19.

Paul Todd and Sarah Wilson, *Textbook on Trusts* (6th ed., Oxford University Press, Oxford, 2003), p.467.

© 2012 Sweet & Maxwell and its Contributors