Problem scenario

Trevor is a trustee of two trusts, Black's Settlement and White's Settlement, each comprising £50,000 in cash. The trust monies are kept in separate bank accounts. Trevor also has a private bank account in which he holds £100,000. Suppose that the following events take place, in the following order:

- Trevor withdraws all the monies from the Black's Settlement account and places them in his own private account.
- Trevor withdraws all the monies from the White's Settlement account and places them in his own private bank account.
- Trevor withdraws £100,000 from his own account in order to purchase a piece of fine art.
- Trevor withdraws £50,000 from his account and uses the monies to pay off the building society mortgage on his house.
- Trevor withdraws the balance of his private account and spends the monies on a luxury world cruise.
- Trevor finally pays £10,000 into his private account.

Trevor has just been declared bankrupt. His general creditors claim the work of fine art which is now worth £150,000, and the balance of monies in Trevor's private account. Advise the beneficiaries of the two trusts, who wish to recover the value of their misappropriated funds.

Guidance

The best way to approach a question on tracing is to arrange the facts of the question under headings representing the various bank accounts, funds and assets, as follows:

Trevor's a/c	Black S a/c	White S a/c	Fine Art	House
£100,000	£50,000	£50,000		
£150,000	nil	£50,000		
£200,000	nil	nil		
£100,000	nil	nil	£100,000	
£50,000	nil	nil	£100,000	£50,000
nil (cruise)	nil	nil	£100,000	£50,000
£10,000	nil	nil	£150,000 (appreciation)	£50,000

The beneficiaries of the Black Settlement and the Beneficiaries of the White Settlement are now seeking to trace their equitable interests through to the £10,000 cash, the £150,000 piece of fine art and Trevor's house.

The first point to make is that tracing at common law will not be possible because the trust monies have been mixed with Trevor's monies in his private account, subject to the possible application of the Rule in *Clayton's* case which is a rule of banking which has the effect of 'unmixing' mixed funds. The Rule in *Clayton's* case will be discussed below, but first we will consider the possibility of equitable tracing.

The great advantages of equitable tracing over common law tracing are, first, that tracing is possible through mixed funds, secondly, that trust beneficiaries can trace in equity and thirdly, that equitable tracing can lead to the assertion of a proprietary right against the defendant's property. In the present case such a right would rank ahead of the claims of Trevor's general creditors. The fact that successful tracing in equity leads to rights in a 'thing' means that the beneficiaries should, in principle, be able to claim some or all of any increase in value of the 'thing'. This will be of particular relevance when we consider the claim against the piece of fine art.

Unfortunately for the beneficiaries, equitable tracing is also subject to certain limitations. The most significant of these for the purpose of the present case is that it is not possible to trace in equity into property which has been purchased in good faith and for value, by a person who had no notice (actual or constructive) of the beneficiaries' rights. This means that the beneficiaries will not be able to trace through to monies of the mortgagee, monies of the cruise organiser or monies of the person who sold the piece of fine art.

Before considering whether equitable tracing will be possible in the present case we will first dismiss the possibility that the rule in *Clayton's* case might be applicable. This rule is sometimes seen as part of the equitable tracing process, but it is more accurate to see it as a peculiar traditional rule of bank accounting which is effective to notionally 'unmix' monies in a mixed bank account. The rule is that where a number of payments are made into and out of a current bank account the first payment in is deemed to be paid out first. Applying the rule in the present case would have the result that Trevor's monies would be deemed to have been used to purchase the piece of fine art (a result which would also flow, incidentally, from the judgment in *Re Hallett's Estate* (1880) 13 ChD 696 which presumes that a trustee uses his own monies before using those of the trust when withdrawing monies from a mixed account to make an unauthorised investment), Black Settlement monies would have been used to reduce the mortgage, and White Settlement monies would have been dissipated on the cruise. The result of applying the rule in *Clayton's* case would, then, be manifestly unfair to the beneficiaries of the White Settlement. In such circumstances the application of the rule would not accord with the presumed intentions of the parties and will not, therefore, be applied (*Vaughan* v *Barlow Clowes* [1992] 4 All ER 717).

We must consider, next, whether equitable tracing will be possible into the piece of fine art, the house and the £10,000 balance in Trevor's a/c. A prerequisite of equitable tracing, that the property has, at some stage, been held in a fiduciary capacity, is clearly satisfied in the present case, by virtue of the fact that Trevor was a trustee. It follows that the beneficiaries should be entitled to a proportionate share in, or a charge over, the various exchange products of their trust monies (*Re Hallett's Estate/ Foskett v McKeown*). But earlier we said that Trevor is deemed to have purchased the piece of art with his own monies, so how can the beneficiaries claim a charge over that? Further, the £10,000 was

paid into an account with a nil balance, so how can those monies be said to represent the trust monies?

A solution to the problem of the piece of fine art is to be found in the judgment in *Re Oatway* [1903] 2 Ch 356. There a trustee had bought shares out of a mixed account of his own monies and trust monies. At the time of the purchase of the shares enough money remained in the account to meet the claims of the trust beneficiaries, but later the balance in the account was dissipated. According to a basic reading of *Re Hallett's Estate* the trustee should be deemed to have withdrawn his own monies first, and therefore the shares would have been his. However, in *Re Oatway*, the court preferred a more sophisticated analysis and refused to allow the trustee in breach to set up a claim to the shares in priority to the claims of the beneficiaries. Similar reasoning would apply in the present case and the trustees should be entitled to a charge over the piece of fine art. If the piece of art is deemed to have been bought entirely with monies from the trusts the charge will be fixed over the whole asset, the beneficiaries will, therefore have an asset worth £150,000 even though their original funds amounted to only £100,000. If the court decides that some of Trevor's own monies are represented in the piece of art the court will probably divide the profit proportionally between Trevor and the trusts (*Foskett v McKeown*), although it might be argued that the trustee should not be permitted to retain any profit from his breach.

Equality between the beneficiaries of the two settlements is presumed throughout as they are all innocent volunteers and together victims of Trevor's accounting malpractice (*Re Diplock* [1948] 1 Ch 465). The overriding principle is that Trevor's interests should be subordinated to those of the innocent parties.