Feature

KEY POINTS

- The rule in *Clayton's Case* is deeply embedded in the banking law of England and Wales and continues to have a fundamental effect as between banker and customer.
- The rule has also been applied to solve problems of distribution between rival claimants exercising tracing remedies in relation to the balance in a bank account, and has received much more criticism in that context.
- The solution to such problems which is currently preferred in England and Wales is to direct a *pari passu* distribution among claimants who can be seen as equal participants in a common misfortune.

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Clayton's Case: the 21st century impact of a 19th century bank failure

The rule in *Clayton's Case* was enunciated just over 200 years ago and has met with both widespread acceptance and widespread criticism. This article examines its fortunes over the last two centuries and its continuing impact today, looking at the unexpected consequences to which it can give rise, the steps which need to be taken to mitigate those consequences and the problems associated with its application in factual contexts completely different from the situation which led to its formulation.

ORIGINS OF THE RULE

On 29 November 1809 William Devaynes died, aged (probably) 79, having been a Member of Parliament for more than 20 years and a director of the Africa Company, the Globe Insurance Company, the French Hospital and the East India Company, of which he was five times the chair. He was also a banker, and it is in that capacity that his name has principally come down in history. At the time of his death, he was the senior partner in the five partner London firm Devaynes, Dawes, Noble & Co and was to all appearances a wealthy man. After his death, the remaining partners carried on the firm business under the same name until they were made bankrupt on 30 July 1810. The failure of Devaynes, Dawes, Noble & Co gave rise to extensive litigation as its creditors sought to draw into the net of potential recovery the assets of Mr Devaynes' estate. Eight lead claimants were identified to argue particular points in a case reported as *Devaynes v Noble* (1816) 1 Mer 529.

One of the lead claimants was a Mr Clayton. He had what was called a cash account at the bank with a credit balance of £1,713 at the date of Mr Devaynes' death. The total of Mr Clayton's subsequent withdrawals before the date of the bankruptcy exceeded that balance, but he also made a higher total amount of further payments in, so that by the time of the bankruptcy his credit balance exceeded £1,713. He proved for that debt in the bankruptcy and received a dividend. He went on to claim from Mr Devayne's estate the sum of £453, the amount standing to his credit following the withdrawals he made after Mr Devayne's death and before making any payments in. He gave proportionate credit for the dividends.

Mr Clayton argued that as he had separate claims to the £453, one against the estate and one against the surviving partners, he had the right to appropriate his later withdrawals to his claim against the surviving partners, with the consequence that no further part of the £453 was repaid. The estate argued that in the absence of special arrangements, each withdrawal extinguished *pro tanto* the debt then owed and did so on the basis that the oldest payments in were repaid first, in the manner set out in the passbooks and statements of account which the firm maintained. Giving judgment, Sir William Grant MR said:

> "… this is the case of a banking account, where all the sums paid in form one blended fund, the parts of which have no longer any distinct existence. Neither banker nor customer ever thinks of saying, this draft is to be placed to the account of the £500 paid in on Monday and this other to the account of the £500 paid in on Tuesday. There is a fund of £1,000 to draw upon, and that is enough. In such a case there is no room for any other appropriation than that which arises from the order in which the receipts and payments take place, and are carried into the account. Presumably, it is the sum first paid in, that is first drawn out. It is the first item on the debit side of the account, that is discharged, or reduced, by the first item on the credit side. The appropriation is made by the very act of setting the two items against each other. Upon that principle, all accounts current are settled, and particularly cash accounts…
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> … It would surprise one to hear the customer say, 'I have been fortunate enough to draw out all that I paid in over the last four years; but there is £1,000, which I paid in five years ago, that I hold myself never to have drawn out; and therefore, if I can find any body who was answerable for the debts of the banking-house, such as they stood five years ago, I have a right to say it is that specific sum which is still due to me, and not the £1,000 I paid in last week."

So was born the rule in *Clayton's Case*, more properly referred to as *Devaynes v Noble: Clayton's Case* (1816) 1 Mer 529, 572.

THE RELATIONSHIP BETWEEN BANKER AND CUSTOMER

These facts are, of course, most unlikely to recur in modern conditions, but the rule nevertheless continues to govern the ordinary relationship between banks and their current account customers unless the presumption on which Sir William Grant based his decision is displaced, as he envisaged might be the case.

This is capable of producing surprising results, both to the detriment of the bank and to its benefit, when the identities of creditor and debtor are in substance reversed and the customer owes money to the bank on an overdrawn account.

Effect of the rule on securities

The first situation is illustrated by *Deeley v Lloyds Bank Limited* [1912] A.C. 757. The facts are that Mr Glaze granted a mortgage to the bank to secure an overdraft limited to £2,500. He later gave a second charge to his sister, Mrs Deeley, to secure money she had lent him. The bank was given notice of the second charge, but the bank manager apparently forgot about the notice and the overdrawn current account continued to be maintained in exactly the same way as previously. The bank eventually took possession and sold the mortgaged property for a sum just sufficient to repay the balance on the account.

Nearly six years later Mrs Deeley began proceedings, contending that, applying the rule in *Clayton's Case*, the amount owed to the bank at the date of the second charge, for which the bank had priority, had been repaid before the bank took possession and sold the mortgaged property and therefore the bank's mortgage had lost its priority. Mrs Deeley was unsuccessful at first instance and in the Court of Appeal, on the ground that the conduct of the parties had excluded the rule, but succeeded in the House of Lords.

The bank has a simple remedy for such a situation, namely, to rule off the account and to apply subsequent transactions to a new account. Indeed, Lloyds Bank had exactly such a rule, but the manager did not apply it. Precautions are now (and have long been) taken against such lapses by clauses in lending documentation which provide for the security to be a continuing security for the balance owing on the account from time to time. In the absence of such a clause or any other special circumstances, however, the rule in *Clayton's Case* will continue to apply with all its vigour.

Effect of the rule on preferential status

The second situation is illustrated by *In re Primrose (Builders) Limited* [1950] Ch. 561. A company in financial difficulties had an overdraft with National Provincial Bank. As those difficulties increased, the bank told the company that it would only permit further drawings to pay wages and then only on terms that the cheques would not be honoured until the manager was satisfied that sums would very shortly be paid in which would be sufficient to ensure that the overdraft was not increased. When the company was eventually compulsorily wound up, the bank claimed to be preferential creditors for the amounts advanced to enable wages to be paid, in accordance with s 319 of the Companies Act 1948 (*cf.* now s 386 of and Sch 6 to the Insolvency Act 1986). The effect of applying the rule in *Clayton's Case* was that, although the further drawings were only permitted on the footing that sufficient payments in to cover the drawings would be made very shortly, when those payments in were made they discharged earlier drawings and not the drawings applied in the payment of wages. The bank manager was concerned to keep the overdraft within its limit, not to appropriate the new payments to the discharge of a particular part of the indebtedness. The bank therefore succeeded in its claim.

COMPETING CLAIMS TO A CREDIT BALANCE

Some criticism may be directed at the consequences of applying the rule in each of these situations, but it has received most criticism, and has been least applied, in cases in which there is more than one claimant to the credit balance in a current account. This is, of course, the exact reverse of the situation in *Clayton's Case* itself.

The starting point: *Re Hallett*

In re Hallett's Estate [1890] Ch. 696 concerned a deceased solicitor, Mr Hallett, who during his lifetime had sold property deposited with him in a fiduciary capacity and paid the proceeds into his current account with his bank. On his death, questions arose as to who was entitled to the sums in the account. Having first decided that the owners of the property could trace the proceeds of sale into the account, the Court of Appeal went on to consider the relative rights of Mr Hallett himself and a client whose property he had sold. Applying the rule in *Clayton's Case*, the result would have been that the client's proceeds of sale had been withdrawn from the account and the remaining balance belonged to Mr Hallett's estate. The majority of the Court of Appeal, allowing an appeal from the decision of Fry J, had no difficulty in holding that the rule was displaced and it must be presumed that Mr Hallett had withdrawn his own funds first, those being the funds which he could honestly withdraw. In so doing, the court overruled an earlier line of authority (in particular, the decision in *Pennell v Deffell* (1853) 4 De G. M. and G. 372).

The effect of that decision was that funds remained in the account for the satisfaction of the claims of both the client and the trustees of Mr Hallett's own marriage settlement, some of the assets of which had similarly found their way into his current account. It was therefore not necessary for the Court of Appeal to decide whether the rule in *Clayton's Case* would apply as between competing parties who had established a right to trace into the account. It seems clear, however, that the members of the court thought that the rule would apply. Further, the question had been a live issue at first instance, with the trustees of the settlement arguing for a rateable division between themselves and the client. Fry J, relying on previous authority, had applied the rule in *Clayton's Case* with the consequence that the trustees received nothing.

Further application of *Clayton's Case*

The Court of Appeal returned to this point some 60 years later, in *In re Diplock* [1948] Ch. 465. Caleb Diplock left a residuary estate of about £263,000 to be applied "for charitable or benevolent … objects" to be selected by his executors, who had distributed some £203,000 to 139 charities before the next-of-kin challenged the validity of the bequest and it was held invalid. Many issues arose in the course of attempts to recover the estate, which included claims to trace into, and through, bank accounts maintained by some of the charities. The Court of Appeal considered the applicability of the rule in *Clayton's Case* by reference to an account maintained by Dr Barnardo's, from which it could clearly be seen that if the rule was applied, a gift of £3,000 had been part of the purchase price of certain loan stock. The court held that the rule did apply and the money could be traced into that stock.

In the course of his judgment, Sir Wilfrid Greene MR said:

> "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. This is really a rule of convenience based upon so-called presumed intention. It has been applied in the case of two beneficiaries whose trust money has been paid into a mixed banking account from which drawings were subsequently made, and, so far as we know, its application has not been adversely criticized (see per Fry J. in *Hallett's* case and per North J. in *In re Stenning*). In such a case both claimants are innocent, neither is in a fiduciary relation to the other, and if the mixed fund had not been drawn upon they would be entitled to rateable charges upon it. Exactly the same occurs where the claimants are not two beneficiaries but one beneficiary and one volunteer, and we think, accordingly, that the same principle should be adopted."

The retreat from *Clayton's Case*

Re Diplock probably represents the high-water mark of judicial support for the application of the rule in *Clayton's Case* to cases involving two or more beneficiaries. Recent decades have seen a strong disinclination on the part of the courts of England and Wales to apply it in such situations, a disinclination which can be found at least equally strongly in other common law jurisdictions.

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The current approach of the courts can be traced to the decision of the Court of Appeal in *Barlow Clowes International Limited v Vaughan* [1992] 4 All E.R. 22. A large number of would-be investors had paid substantial sums to Barlow Clowes for investment. Those investments had not been made and funds remained in bank accounts, which were nevertheless inadequate to meet all the claims. It was necessary to decide on the relative rights of the investors to those funds. Three theoretical possibilities were identified:

- To apply the rule in *Clayton's Case*, which would benefit a small number of investors to the detriment of the many.
- To direct a *pari passu* distribution on the basis of the amounts paid over.
- The "North American" solution, under which each withdrawal would be attributed rateably to those who had by then invested.

The North American solution was, however, purely theoretical, because no one was asking for it, given its complexities and cost. The outcome was that, on the facts, investors were treated as having invested in a common investment fund as soon as money was paid into the Barlow Clowes accounts, with the consequence that the balance in the accounts was distributed *pari passu* and, to the extent that investments had been acquired from the funds in the accounts, the investors were entitled rateably to the investments.

All the members of the court regarded the application of the rule in *Clayton's Case* in the context of beneficiaries claiming to trace into a current account as likely to produce injustice, compared with the greater degree of fairness to be achieved by the North American solution, but they regarded it as settled law, short of the House of Lords, that the rule was capable of applying. Nevertheless, it is a rule based on a presumption and the question then becomes whether, on the facts of a particular case, the rule is excluded.

In *Russell-Cooke Trust Company v Prentis* [2002] EWHC 2227 (Ch), [2003] 2 All E.R. 478 Lindsay J had to return to this issue. In that case Mr Prentis, a solicitor, had invited funds to be placed out in secured loans. Substantial sums were received and some investments were made, but the Law Society intervened in Mr Prentis's practice and there were found to be significant shortfalls. Among the issues raised was the question of the beneficial ownership of an account known as the No 2 account. The judge referred to *Barlow Clowes* and the three possible solutions there identified and said, at para 55:

> "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. Thus in *Barlow Clowes* supra Woolf L.J. after a full citation of the authorities - pages 36-39F and 39H-40G - held that the rule did not apply where circumstances from which a counter intention might be presumed were found - page 41. Such relevant circumstances

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could include acts and omissions after the investor had made his investment and also the injustice between investors if a rule so arbitrary in its effects were to be imposed - page 42E-H. Leggatt L.J. also saw the rule as capable of being displaced by a presumed intention - page 46B-C. He regarded it as capricious, arbitrary and inapposite - page 46F-J. It is plain from all three of the judgments in *Barlow Clowes*, the third being that of Dillon L.J., that the rule can be displaced by even a slight counterweight. Indeed, in terms of its actual application between beneficiaries who have in any sense met a shared misfortune, it might be more accurate to refer to the exception that is, rather than the rule in, *Clayton's case*."

Lindsay J went on to find "an available counterweight" on the basis that a reasonable contemplation from the publicity material and the actual facts showed that the rule was displaced. It was not intended to apply payments in strict temporal order and that did not happen in fact. The principal reason for adopting the North American solution, that it was fairer than the rule in *Clayton's Case*, thus did not apply and it was, in any event "complicated and may be expensive to apply". He preferred to adopt the *pari passu* solution, which he regarded as the least unfair system for distribution of loss on an account which ought to have been dealt with in accordance with the Solicitors' Accounts rules.

More recently, Henderson J had to consider the applicable principles in *Charity Commission for England and Wales v Framjee* [2014] EWHC 2505, [2015] 1 W.L.R. 16. The case concerned the Dove Trust, an unincorporated charitable trust which operated a website inviting members of the public to make donations to the Trust for application to the charity of the donor's choice. A Charity Commission inquiry revealed a substantial shortfall between the sums held by the Trust and the sums due to charities designated by donors. Among the questions which the court had to consider was the question how the remaining funds held by the Trust should be distributed.

Having referred to the three solutions identified in *Barlow Clowes*, the judge rejected the application of the rule in *Clayton's Case* on the ground that no one was arguing for it, it produced arbitrary results and was relatively easily displaced if a fairer solution was available and it would be prohibitively expensive. *Pari passu* distribution, which he described as having "the great advantage of being simple and inexpensive to implement", was regarded as a fairer solution which was available, but he also considered the arguments in favour of what was described as a modified version of the North American approach. Some modification was necessary because the raw data required for the classic North American approach was not available without a wholly impractical reconstitution exercise. The modified approach was to create two pools, one of donations made before 6 June 2013, the last date on which distributions were made out of the accounts, and one of donations made afterwards.

The principal argument in favour of the two-pool approach was that the shortcomings in administration which had occurred prior to 6 June 2013 and allowed the shortfall at that date to develop would then not affect those who had contributed after that date, which was also the date of the appointment of the interim manager, although the appointment was not immediately announced. The modified approach would also avoid the problems of impracticality and expense which otherwise affect the North American solution. It was, however, rejected by Henderson J on two grounds:

- the website operated in exactly the same way before and after 6 June 2013, so that the fairest solution was to treat all donors as participants in a common misfortune; and
- there could not be any principled basis for applying the North American approach in part only, as was effectively being proposed.

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CONCLUSIONS

We may therefore conclude:

- The rule in *Clayton's Case* retains its full vigour in its original sphere of the relationship between banker and customer.
- Banks need to continue the practice of excluding the rule where its application could prejudice reliance on security held for the repayment of indebtedness on an overdrawn account.
- The rule still nominally applies also where a dispute arises between different claimants having a right to trace into a customer's account, but the potential unfairness of applying the rule means that it will very easily be displaced.
- In the courts of England and Wales, the likelihood is that it will be displaced in favour of a *pari passu* distribution rather than in favour of the rolling cycle approach preferred in North America. ■

Further Reading:

- Drafting security documentation to rebut the presumption in *Clayton's case*: continuing security and ruling off provisions (2014) 1 JIBFL 74.
- Reforming Priority law (2006) 1 JIBFL 4.
- LexisPSL: Banking & Finance: Should the ruling off provisions in a guarantee apply to the account of the principal debtor or the account of the guarantor?