THE SHORTFALL CONUNDRUM: A NEW FRAMEWORK FOR ALLOCATING LOSSES IN A MIXED FUND IN AUSTRALIA

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This article analyses the various methods available to courts in Australia for allocating a loss of trust funds to the beneficiaries of a mixed fund. These distinct methods can be used to allocate a shortfall of trust funds that has occurred due to a fraudulent misappropriation committed by the trustee or as a result of other operational risks. There is still a debate in Australia over the best method for allocating any losses to beneficiaries when there is a shortfall in a mixed fund. Significantly, this article introduces a new practical framework with guidelines for allocating losses in a mixed fund in order to enhance legal certainty for beneficiaries, trustees, insolvency administrators, and courts. It also introduces a new method of distribution that beneficiaries can adopt. The new framework considers the intention (actual or presumed) of the beneficiaries to be the main factor for determining the method of distribution that is applied in allocating a shortfall.

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I Introduction

There is a fervent and ongoing debate in Australia over the best method for distributing trust funds to beneficiaries whose funds have been 'commingled'[1] in an account (ie a 'mixed fund')[2] and have subsequently suffered a shortfall due to fraudulent misappropriation[3] committed by the trustee or as a result of other operational risks.[4] The shortfall conundrum has arisen under the following typical scenario: a trustee ('T') commingles the funds of three beneficiaries ('B1', 'B2', and 'B3') over a period of time in a single trust account. For example, B1 deposits $100 on day 1; B2 deposits $100 on day 2;

[1] 'Commingling' means that the funds of multiple beneficiaries and/or the trustee have been 'mixed' together in a single consolidated or omnibus account.

[2] In *Re Global Finance Group Pty Ltd (in liq); Ex parte Read* (2002) 26 WAR 385 ('*Re Global Finance*'), McLure J observed that '[a] mixed fund is one which contains funds from more than one source': at 407 [97]. This article uses the terms 'mixed fund' and 'commingled account' interchangeably.

[3] 'Misappropriation' means that the trustee used the trust funds for a non-authorised purpose in breach of trust. This article uses the terms 'misappropriation' and 'defalcation' interchangeably.

[4] 'Operational risk' is the risk of human error or a breakdown of some component of the hardware, software, or communications systems that are crucial for record keeping and the protection of beneficiary funds.

T misappropriates $100 on day 3; B3 deposits $100 on day 4; T declares bankruptcy on day 5, leaving a shortfall of $100 in the account.

Courts in Australia have struggled to select the appropriate method for allocating the losses among the claimant beneficiaries and distributing the remaining funds. This article provides insolvency administrators and courts with a new practical framework for allocating losses in a shortfall situation in a fair and reliable manner. Adherence to the guidelines in the framework should reduce the number of cases that are litigated by providing an *ex ante* plan to the beneficiaries of a mixed fund for distributing the remaining trust funds in a shortfall situation upon the bankruptcy of the trustee. The framework also provides courts with practical solutions for the more complex cases that are litigated.

First, this article argues that insolvency administrators and judges should first consider the express or implied intention of the beneficiaries on a case-by-case basis when deciding which method of distribution to apply.[5] The *express intention* can be determined from the oral or written contractual dealings in the trust documentation between the trustee and the beneficiaries. Alternatively, the *implied intention* can be ascertained from the previous business dealings between the trustee and the beneficiaries, or if the beneficiaries can demonstrate that the trustee has adhered to a particular custom or practice for holding trust funds.

This article analyses the most common methods that beneficiaries can choose to allocate a shortfall, including: (1) the original lowest intermediate balance rule ('LIBR'); (2) the LIBR–pro-rata hybrid rule ('Hybrid Rule') — either (a) the 'claims' version, or (b) the 'rolling charge' or 'North American' version; (3) the pro-rata approach; (4) the rule in *Clayton's Case*[6] or first in, first out ('FIFO'). Significantly, this article makes an original contribution to the existing legal literature by developing a new method based on the rule in *Clayton's Case* that beneficiaries can adopt to allocate a shortfall, which I have called the FIFO–pro-rata hybrid rule.

As a general rule, it is argued that courts in Australia should apply the North American version of the Hybrid Rule in cases where the beneficiaries

[5] For additional information on the various distribution methods, see generally Christian Chamorro-Courtland, 'Demystifying the Lowest Intermediate Balance Rule: The Legal Principles Governing the Distribution of Funds to Beneficiaries of a Commingled Trust Account for Which a Shortfall Exists' (2014) 30(1) *Banking and Finance Law Review* 39 ('Demystifying the LIBR').

[6] *Devaynes v Noble; Clayton's Case* (1816) 1 Mer 529; 35 ER 767, 781 (Chancery) ('*Clayton's Case*').

expressly intended to fully or legally segregate their funds.[7] Courts should also apply the pro-rata approach in cases where the beneficiaries expressly intended to hold their funds as co-owners in an omnibus account,[8] or where they expressly intended to segregate their funds, but tracing has become too complex or costly due to inaccurate or incomplete account records.

Where the express or implied intention of the beneficiaries remains unclear, it is argued that there should be a legal presumption that beneficiaries whose funds are held in a mixed fund intended to segregate their funds from each other and to distribute them using the Hybrid Rule. This presumption is justified as a general rule, since it would be irrational and unfair to presume that the beneficiaries would consent to sharing co-ownership risks with the other beneficiaries in a mixed fund without their prior knowledge or approval.[9]

Second, this article analyses situations where the trustee has wrongfully commingled its own funds in the commingled account with the funds of the beneficiaries. It is argued that there should be a legal presumption that a trustee intended to subordinate its interests to the beneficiaries' interests. Consequently, a trustee will lose its own funds first if there is a shortfall of trust funds in the mixed fund in an insolvency situation. It is also argued that where the trustee replenishes any missing trust funds by depositing its own personal funds into the mixed fund, there should be a legal presumption that the trustee intended to reimburse the trust funds.

Third, this article provides a framework to help insolvency administrators and courts in determining which rule to apply in a shortfall situation. Most of the case law in Australia deals with scenarios where investors have transferred funds to a broker to invest in a scheme (usually a property investment

7 'Segregation' is a method for protecting a beneficiary's assets by identifying them separately from the assets of the trustee and the other beneficiaries. The trustee can achieve this by depositing the funds of each beneficiary in an individualised account, or by depositing the funds of all the beneficiaries in a single commingled (or 'omnibus') account and keeping a separate ledger for each individual beneficiary (legal segregation with operational commingling ('LSOC')). The beneficiaries who want their funds legally segregated do so with the intention of avoiding sharing any risk as co-owners with the other beneficiaries.

8 An 'omnibus account' is a single account for the commingled funds or positions of multiple parties: 'Committee on Payments and Market Infrastructures: Glossary', *Bank for International Settlements* (Web Page, 17 October 2016) <https://www.bis.org/cpmi/publ/d00b.htm>, archived at <https://perma.cc/2HHQ-N6K5>.

9 Chamorro-Courtland, 'Demystifying the LIBR' (n 5) 47.

scheme).[10] Other cases deal with scenarios where a lawyer commingles the funds of multiple clients in a single account. As more fraudulent schemes are bound to be uncovered in Australia in the future, this article provides administrators and courts with a reliable framework for allocating losses in order to enhance legal certainty for the beneficiaries and unsecured creditors of an insolvent trustee.

II Tracing

The distribution methods that are analysed in the following sections form a part of the law of tracing:

> Tracing is … neither a claim nor a remedy. It is merely the process by which a claimant demonstrates what has happened to his property, identifies its proceeds and the persons who have handled or received them, and justifies his claim that the proceeds can properly be regarded as representing his property.[11]

The orthodox position in many common law jurisdictions is that it is not possible to trace at common law into and out of a mixed fund because the commingled funds lose their identity.[12] Conversely, it is possible to trace into and out of a mixed fund in equity; however, this distinction has been criticised.[13] In order to avoid a lengthy theoretical debate, this article will not distinguish between tracing at common law and tracing at equity.

[10] This article does not apply to cases where the trustee is operating as a 'financial services licensee' and providing a 'financial service' or a 'financial product' to a client. These types of trustees are regulated under the *Corporations Act 2001* (Cth) ch 7: see at s 761A (definitions).

[11] *Foskett v McKeown* [2001] 1 AC 102, 128 (Lord Millett).

[12] *Agip (Africa) Ltd v Jackson* [1990] 1 Ch 265, 286 (Millett J), affd [1991] Ch 547, 566 (Fox LJ, Butler-Sloss LJ agreeing at 570, Beldam LJ agreeing at 570). This dictum has been approved in Singapore (*Sumitomo Bank Ltd v Thahir Kartika Ratna* [1992] 3 SLR(R) 638, 708–9 [186]–[188] (Lai Kew Chai J) (High Court)); the UK (*El Ajou v Dollar Land Holdings plc* [1993] 3 All ER 717, 733 (Millett J) (Chancery Division); *Bank Tejarat v Hong Kong and Shanghai Banking Corporation (CI) Ltd* [1995] 1 Lloyd's Rep 239, 245 (Tuckey J) (Queen's Bench Division)); Canada (*The Citadel General Assurance Co v Lloyds Bank Canada* [1997] 3 SCR 805, 841–2 [57] (La Forest J)); and New Zealand (*Equiticorp Industries Group Ltd (in stat mgmt) v The Crown [No 47]* [1998] 2 NZLR 481, 697–8 (Smellie J) (High Court)).

[13] Justice J Edelman, 'Understanding Tracing Rules' (2016) 16(2) *QUT Law Review* 1, 2; Tatiana Cutts, 'Tracing, Value and Transactions' (2016) 79(3) *Modern Law Review* 381, 387.

A *Theories of Tracing*

Although this article mainly focuses on the *practical* aspects of allocating shortfalls in a mixed fund, the following section will provide a brief overview of the theoretical debate that is taking place in common law jurisdictions as to the conceptual premise of tracing. Justice Edelman has noted that 'the judiciary has never enunciated the assumptions, or normative premises, upon which the law of tracing has been built'.[14] This has led to an emergence of various theories on the law of tracing.

The 'tracing value' school of thought requires claimants to follow a continuous thread of 'value' from one right to another. Professor Smith has provided the following example:

> Consider the simplest case in which the plaintiff's asset is exchanged by a defendant for some other asset, and the plaintiff wants to trace into the new asset. The only connection which the plaintiff has to the new asset is that it was acquired with the old asset. The defendant acquired the value inherent in the new asset with the value inherent in the old asset. That is why we say we trace value: it is the only constant that exists before, through and after the substitution through which we trace. It exists in a different form after the substitution, and that is what can justify a claim to the new asset.[15]

However, Dr Cutts has criticised this theory by arguing that the concept of moving and exchanging value through a transaction is unclear and 'theoretically and practically misleading'.[16]

The 'causally linked transactions' school of thought requires the claimants 'to establish a causal link between two or more transactions. It requires that the latter transaction would not have occurred "but for" the earlier defective transaction'.[17] This theory requires a 'transactional link' that forms part of an unbroken chain between the claimant's misappropriated property and the substituted property that is being claimed.[18] However, this theory has been criticised as it does not work in cases where the claimants need to trace backwards. In other words, it does not work where a 'defective transaction occurs *after* the transaction with the defendant, but a fraudster intends to use

[14] Edelman (n 13) 1.

[15] Lionel D Smith, *The Law of Tracing* (Oxford University Press, 1997) 119.

[16] Cutts (n 13) 392–6.

[17] Edelman (n 13) 11.

[18] *OJSC OIL Co Yugraneft (in liq) v Abramovich* [2008] EWHC 2613 (Comm), [349] (Clarke J).

the proceeds from the later transaction in the earlier defective transaction'.[19] Cutts has also criticised this orthodox theory because it has become increasingly onerous for a claimant to demonstrate that the chain of transactions remained unbroken, 'not least because a fraudulent fiduciary is unlikely to be forthcoming in their evidence as to the path of misdirected funds'.[20] This theory has also been rejected by Evans, who has argued that beneficiaries who are seeking to trace should be freed from the obligation of proving a transactional link.[21]

Cutts has argued under the 'intentional transactions' school of thought that

> in order to determine the existence, content and type of transaction the parties have created, the court will have reference to their intention, deduced from the agreement as a whole. If this intention, so deduced, reveals that several transactions are interdependent, the intermediate steps will be ignored in determining their overall effect.[22]

Cutts has also argued that this theory 'allows us to overcome the obstacles apparently created by instances of multiple intermediate accounts, clearing and credit'.[23] This view of tracing should also allow courts to overcome the obstacles created by instances of allocating a shortfall in a mixed fund. It is argued that, of the various main theories on tracing, the 'intentional transactions' theory of tracing is the most compatible with the practical framework and guidelines laid out in this article for allocating losses in a mixed fund.

B *Fictional Tracing Rules*

Courts of equity have created various 'fictional' methods of distribution in order to overcome existing tensions regarding the theoretical nature of tracing and to facilitate the tracing process when there is a shortfall in a mixed fund, as trust funds in the account may no longer be identifiable. Cutts has observed that

[19] Edelman (n 13) 11 (emphasis in original).

[20] Cutts (n 13) 384.

[21] Simon Evans, 'Rethinking Tracing and the Law of Restitution' (1999) 115 (July) *Law Quarterly Review* 469, 479–80.

[22] Cutts (n 13) 399.

[23] Ibid 400.

> [o]n occasion … judges have cited 'considerations of justice and practicality' in departing from received orthodoxy to produce a result less jarring to lay perceptions of right and wrong. The effect is to produce a climate in which the content of the pertinent principles, and the effect of their application to the facts of a particular case, are exceedingly difficult to predict.[24]

Furthermore, Crabtree has argued that

> [o]nce it is accepted that tracing is purely an evidential process, it is clear that the rules of tracing are legal presumptions or fictions. This in turn means that the rules will necessarily be 'arbitrary'. As evidential presumptions, they will not reflect 'reality', but rather will be informed by issues of policy …[25]

Stoddard has also noted that

> [s]ince it is impossible to answer this question in the 'actual' sense of identifying exactly which dollars remain, equity substitutes a fictional answer in these cases, such that courts are able to deal with these complicated questions. As a result, the goal of 'tracing' is not to trace anything at all in many cases, but rather serves as an equitable substitute for the impossibility of specific identification.[26]

Therefore, the rules of distribution created by courts of equity 'operate as equity's equivalent of bankruptcy allocations'.[27] These fictional rules provide insolvency administrators and courts with various tools to allocate losses among the beneficiaries in a shortfall situation.[28]

Cutts has correctly observed that since 'most fraudsters will attempt to conceal the path of funds by some transactional contortion, the absence of a set of guiding principles is no small problem for clarity and consistency in this

[24] Cutts (n 13) 384–5 (citations omitted). Cutts cites *Brazil v Durant International Corporation* [2016] AC 297, 306 [13] (Lord Toulson JSC) (Privy Council) ('*Brazil*') as authority for the proposition that courts have departed from the orthodox position of requiring an unbroken chain to be able to trace through a payment system: Cutts (n 13) 384 n 20.

[25] Joseph Crabtree, 'Tracing, Property Rights, and Discretion' (2000) 6(3) *New Zealand Business Law Quarterly* 222, 224.

[26] William Stoddard, 'Tracing Principles in Revised Article 9 § 9-315(b)(2): A Matter of Careless Drafting, or an Invitation to Creative Lawyering?' (2002) 3(1) *Nevada Law Journal* 135, 142.

[27] Susan Barkehall Thomas, 'Clayton's Case and the "Common Pool" Exception' (2004) 15(3) *Journal of Banking and Finance Law and Practice* 177, 189 ('Common Pool Exception').

[28] Liquidators and administrators in Australia can also apply to the court for advice on which distribution method to apply in the liquidation of trust property: see, eg, *Trustee Act 1925* (NSW) s 63(1).

area of private law'.[29] In order to increase legal certainty, this article provides a practical set of guiding principles for courts and administrators to allocate a shortfall in a mixed fund in a principled manner.

The following sections will consider the main distribution methods that have been adopted by courts in Australia for allocating shortfalls. It should be noted that the various distribution rules apply in situations where there is a designated trust account or where the trustee has commingled trust funds in its own personal account. For practical purposes, this article only deals with tracing funds *into* a commingled account and deliberately omits dealing with situations of tracing funds *out* of the account.[30]

III The Basic Pro-Rata Rule

The 'basic pro-rata rule' based on original contributions (also referred to as 'pro rata ex post facto',[31] 'pari passu ex post facto',[32] or the 'rateable solution'[33]) provides beneficiaries with a share in the remaining trust funds in a commingled account in proportion to their original contributions. First, equitable principles provide the beneficiaries of the commingled trust account with an 'equitable charge or lien on the whole of the remaining unused common fund',[34] which 'is held jointly with all of the other contributors to the mixed

[29] Cutts (n 13) 392.

[30] The High Court of Australia's decision in *Scott v Scott* (1963) 109 CLR 649 provides an additional safety net for beneficiaries who can trace their funds out of the account. This decision held that beneficiaries who can trace *out* of a mixed fund and into a particular asset that is purchased without authority by the trustee can claim a proportionate beneficial interest in that asset.

[31] *Boughner v Greyhawk Equity Partners Ltd Partnership (Millenium)* (2012) 111 OR (3d) 700, 702 [2] (Morawetz J) (Superior Court of Justice) ('*Boughner*'), affd [2013] ONCA 26.

[32] Barkehall Thomas, 'Common Pool Exception' (n 27) 180.

[33] *Australian Securities and Investments Commission v Nelson* (2003) 44 ACSR 719, 723 [24] (Austin J) (Supreme Court of New South Wales) ('*Nelson*').

[34] *Australian Securities and Investments Commission v Letten [No 7]* (2010) 190 FCR 59, 121 [282] (Gordon J) ('*Letten*'). Courts in Canada and the US provide beneficiaries with the choice of asserting an equitable charge, an equitable lien, or a constructive trust over the remaining fund after completing a tracing exercise. See *Re Ontario Securities Commission and Greymac Credit Corp* (1986) 30 DLR (4th) 1, 8 (Morden JA for the Court) (Ontario Court of Appeal) ('*Greymac*'); *Korkontzilas v Soulos* [1997] 2 SCR 217, 241 [45] (McLachlin J); *Re Mahan & Rowsey Inc; Turley v Mahan & Rowsey Inc*, 35 BR 898, 902–3 [4]–[7] (Berry J) (Bankr WD Okla, 1983) ('*Re Mahan*'). It is unclear in Australia whether beneficiaries can also assert a constructive trust. Further research is necessary to determine whether one option provides a better solution to beneficiaries over the other.

fund'.[35] Second, the pro-rata rule

> 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.[36]

For example, B1's, B2's, and B3's trust funds are commingled in a single trust account by T: B1 deposits $100 on day 1; B2 deposits $100 on day 2; T misappropriates $100 on day 3; B3 deposits $100 on day 4; T declares bankruptcy on day 5. The basic pro-rata rule provides B1, B2, and B3 with an equitable charge over the remaining $200 in the account and each will receive one third of the remaining trust funds ($66.66).

A *Analysis*

This rule has been favoured by courts in Australia[37] in complex cases dealing with mixed funds because

> it has the advantage of simplicity. The rule is easy to apply, and also has an intuitive appeal, as it ensures that all beneficiaries have equal treatment. The beneficiaries whose allocation was fortuitous get no better treatment than beneficiaries who cannot prove their money was used towards a specific loan. It confirms the status of all beneficiaries as equally innocent victims of a fraudulent trustee.[38]

For example, the pro-rata rule was applied in *Australian Securities and Investments Commission v Letten [No 7]* ('*Letten*')[39] because it would be too complex and prohibitively costly to reconstruct the transaction records in

[35] Samantha Kinsey and Leana Papaelia, 'Distribution of a Mixed Fund: Pragmatism Prevails over Esoteric Tracing Principles' (2012) 20(4) *Insolvency Law Journal* 264, 267.

[36] *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22, 36 (Woolf LJ) (Court of Appeal) ('*Barlow Clowes*').

[37] The pro-rata rule was applied in the following cases: *Australian Securities Commission v Melbourne Asset Management Nominees Pty Ltd (rec and mgr apptd)* (1994) 49 FCR 334; *Australian Securities and Investments Commission v Enterprise Solutions 2000 Pty Ltd* [2001] QSC 82; *Nelson* (n 33); *Australian Securities and Investments Commission v Tasman Investment Management Ltd* (2006) 202 FLR 343 (Supreme Court of New South Wales); *Hannan v Zindilis* (2016) 51 VR 178 ('*Hannan*').

[38] Susan Barkehall Thomas, 'Tracing into an Overdrawn Mixed Bank Account' (2004) 12(2) *Insolvency Law Journal* 95, 102 ('Tracing').

[39] *Letten* (n 34).

order to be able to trace the trust funds into and out of the relevant trust accounts. Gordon J estimated that an attempt to trace the approximately 110,000 transactions which took place in relation to the trust accounts, plus the distributions to the beneficiaries, would cost approximately $18 million.[40] Her Honour held:

> Even if the tracing exercise could be completed (and it cannot), in the circumstances of this case it is not justifiable to reduce the available funds for distribution to investors by $18 million (the approximate cost of the tracing exercise) out of a possible fund of $13 to 14 million (after payment of secured creditors) …[41]

Courts in Australia have applied the pro-rata rule in cases where it was necessary as a practical solution because it was too complex, costly or time-consuming to trace, or impossible to identify, the trust funds of specific beneficiaries in a commingled account due to inaccurate or incomplete account records. However, it is argued that the pro-rata rule is not, and should not, become the general default rule for distributing trust funds in Australia in situations where the intention of the beneficiaries is unclear. The pro-rata rule has only, and should only, be applied by courts in extremely complex situations or in situations where the beneficiaries of a trust intended to share risk equally as co-owners.

As will be seen below, judges in Australia have considered applying, and have applied, other distribution methods.[42] The basic pro-rata approach has been rejected in Australia as the general default rule in situations where the intention of the beneficiaries is unclear.[43] It has received both judicial and academic criticism. For example, Campbell J in *Re Sutherland; French Caledonia Travel Service Pty Ltd (in liq)* ('*Re Sutherland*')[44] held that 'it cannot be said that, as a matter of law, a fund in which assets of several beneficiaries

[40] Ibid 113 [258].

[41] Ibid 113 [259].

[42] The Courts in *Travel Compensation Fund v Classic International Cruises Pty Ltd (in liq)* [2014] NSWSC 167 ('*Travel Compensation Fund*') and *Re National Buildplan Group Pty Ltd* [2014] NSWSC 146 considered the Hybrid Rule; however, the Courts applied the pro-rata rule due to the cost and complexity of applying another tracing rule: *Travel Compensation Fund* (n 42) [26]–[29] (Black J); *Re National Buildplan Group Pty Ltd* (n 42) [25] (Black J).

[43] *Re Sutherland; French Caledonia Travel Service Pty Ltd (in liq)* (2003) 59 NSWLR 361, 420 [185], [187] (Campbell J) ('*Re Sutherland*').

[44] *Re Sutherland* (n 43).

have become mixed should always be distributed amongst all beneficiaries, pro rata to their claims'.[45]

The authors of *Waters' Law of Trusts in Canada* have argued that '[a]lthough there is clearly a certain fairness in proportionate sharing, this approach shifts earlier losses onto later contributors, whose money could not possibly have been implicated in those losses'.[46] Consequently, pro-rata distribution forces victims that deposited their money later in the account to subsidise earlier victims that deposited their money before any misappropriations occurred.

Smith has also criticised the pro-rata approach as the general default rule and argued that

> [w]hatever benefits may flow from the use of mixed trust accounts by lawyers and others, it would be pure fiction to suppose that the clients had formed a *common intention* to embark upon some kind of joint venture, sharing losses like partners.[47]

It is argued therefore that in cases where there are accurate and complete records of transactions into and out of the commingled trust account, courts should not apply the pro-rata method unless the beneficiaries had a common intention to hold the funds as co-owners.

Moreover, Professors Yates and Montagu have criticised the pro-rata approach as the default rule and argued that 'it is difficult to see how removing property rights and giving instead a pro-rata share in a cash amount which is exposed to losses incurred by other clients is "more equitable"'.[48]

Overall, it is argued that the pro-rata rule is not, and should not, become the general default rule for allocating shortfalls in a mixed fund in Australia where the intention of the beneficiaries is unclear. The pro-rata approach should only be applied in situations where: (1) the beneficiaries intended to share the risk as co-owners; and (2) where it is too complex or time-consuming to apply another rule of distribution (eg the Hybrid Rule).

[45] Ibid 420 [185]. It should be noted that after considering the various distribution methods available to the Court, Campbell J ended up applying the pro-rata rule in this case due to a concern that the remaining trust funds would be depleted if the liquidator carried out an extensive tracing analysis: at 422 [193].

[46] Donovan WM Waters, Mark R Gillen and Lionel D Smith (eds), *Waters' Law of Trusts in Canada* (Thomson Carswell, 3rd ed, 2005) 1283.

[47] Lionel Smith, 'Tracing in Bank Accounts: The Lowest Intermediate Balance Rule on Trial' (2000) 33(1) *Canadian Business Law Journal* 75, 90 (emphasis added).

[48] Madeleine Yates and Gerald Montagu, *The Law of Global Custody: Legal Risk Management in Securities Investment and Collateral* (Bloomsbury, 4th ed, 2013) 191 [7.160].

IV The Original Lowest Intermediate Balance Rule

The LIBR has been the source of some confusion in both the case law and the academic literature in common law jurisdictions. This article proposes to put an end to the confusion. The UK Privy Council recently provided the following description of the LIBR:

> [W]here a claimant's money is mixed with other money, and drawings are made on the account which reduce the balance at any time to less than the amount which can be said to represent the claimant's money, the amount which the claimant can thereafter recover is limited to the maximum that can be regarded as representing his money …[49]

For example, if a beneficiary ('B') provides T with \$20 to deposit in a trust account, and T later misappropriates \$15, the most that B can claim in the account is \$5, which is the lowest balance in the account.

A *The Origins of the LIBR*

The LIBR originated in the English case of *James Roscoe (Bolton) Ltd v Winder* ('*James Roscoe*').[50] That case dealt with a situation where Mr Wigham (the trustee) commingled the trust funds of James Roscoe Ltd (the beneficiary) with his personal funds in his personal account. The trustee deposited £455 belonging to the beneficiary in his personal account. The trustee spent all but £25 and then replenished the account with £333 of his own money, which left £358 in the account at the time of his death.[51]

Sargant J held that the beneficiary was only allowed to trace into the account and claim the lowest intermediate balance, which was £25.[52] The remaining £333 was successfully claimed by Mr Wigham's trustee in bankruptcy to pay his other unsecured creditors. Dr Barkehall Thomas has explained that

> [t]here were two bases for the decision. The first was that the trust money had clearly been spent, and the trustee could not be presumed to have intended to

[49] *Brazil* (n 24) 305 [11] (Lord Toulson JSC).

[50] [1915] 1 Ch 62 ('*James Roscoe*').

[51] Ibid 62–3.

[52] Ibid 70. However, I would argue that the outcome of this case was incorrect. According to the arguments that I make below, the personal funds of the trustee should have replenished the depleted trust fund, which means that the beneficiary should have been able to claim the £333: see below Part IV(F)(1).

> replenish the trust. More importantly, it was also held that it was impossible to trace the funds into the account at the date of the claim.[53]

This dictum was followed in Australia in *Re MacDonald*,[54] which applied the LIBR to the facts of the case.[55]

B *Analysis*

The following observations can be made about the original LIBR. First, like the other tracing rules, 'the lowest intermediate balance rule is not really a tracing principle, but rather it is a convenient equitable device for fictional tracing in situations where real tracing is impossible'.[56] The rule 'is based on the premise that tracing rights are predicated on the model of property rights'.[57] The Ontario Court of Appeal has held that

> a claimant to a mixed fund cannot assert a proprietary interest in that fund in excess of the smallest balance in the fund during the interval between the original contribution and the time when a claim with respect to that contribution is being made against the fund …[58]

This means that once the funds have left the account as evidenced by the ledger, it is no longer possible for the beneficiary to trace the funds into the commingled account. It may only be possible for the beneficiary to trace the funds out of the account. This was explained by Campbell J in *Re Sutherland*:

> *James Roscoe v Winder* is authority for the 'lowest intermediate balance rule'. Under it, 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. In a case where the type of tracing being attempted involves detailed analysis of what has become of the property of a particular beneficiary, and into what other assets it has been converted or mixed, *the lowest intermediate balance rule is fundamental to a*

53 Barkehall Thomas, 'Tracing' (n 38) 96.

54 [1975] Qd R 255.

55 Ibid 258–9 (Campbell J).

56 Stoddard (n 26) 147.

57 *Hannan* (n 37) 185 [26] (McMillan J).

58 *Law Society of Upper Canada v Toronto-Dominion Bank* (1998) 169 DLR (4th) 353, 360 [14] (Blair J) ('*LSUC*'), quoted in Anthony Duggan, 'The Death and Resurrection of the Lowest Intermediate Balance Rule' (2017) 80(1) *Saskatchewan Law Review* 209, 209–10.

> *principled approach to tracing*. Remembering that the aim of tracing is to identify property which is still in the hands of a defendant, and which can be seen to be in substance the property of the plaintiff, no more than the lowest intermediate balance in a mixed account can meet that test. It is only to the extent of the lowest intermediate balance that the beneficiary can say 'you cannot in conscience deny that your right to get money out of your bank account is property which you hold on trust, and which you must put back into the trust fund'.[59]

Second, the LIBR was designed for cases where a single beneficiary's trust funds have been mixed with non-trust funds (eg the trustee's personal funds),[60] meaning that it generally applies in a beneficiary–trustee dispute.[61] In *Hannan v Zindilis* ('*Hannan*'),[62] McMillan J observed that

> [t]he lowest intermediate balance rule has been criticised for its complexity and difficulty to apply in situations involving more than just a small number of competing beneficiaries. Indeed, the mechanics of the rule appear better suited to resolving competition between beneficiaries and a defaulting trustee, rather than the claims of competing innocent beneficiaries.[63]

A beneficiary–trustee dispute typically occurs in situations where the trustee wrongfully commingles a beneficiary's trust funds in the trustee's personal bank account. As is explained further below, the LIBR may not work effectively in situations where the funds of multiple beneficiaries in a commingled account are misappropriated *simultaneously*, as it is not possible to determine which beneficiary's funds are being misappropriated by the trustee.

For example, B1 and B2 each deposit $10 with T on day 1; T misappropriates $8 on day 2, and then declares bankruptcy on day 3, leaving $12 in the account. As it is not possible to determine which beneficiary's funds were misappropriated, it is not possible to apply the LIBR to the facts of this case. As a result, courts will need to apply the pro-rata approach to resolve this issue, as the original LIBR cannot operate effectively in situations where multiple beneficiaries experience a simultaneous loss.

[59] *Re Sutherland* (n 43) 417–18 [175] (emphasis added).

[60] See Barkehall Thomas, 'Common Pool Exception' (n 27) 181 n 15:

> In *Re Handy and Harman Refining Group Inc* 266 BR 24 (2001, Bankruptcy Court for the District of Connecticut) the court held the lowest intermediate balance rule was (at 29) 'applicable only to situations where trust funds are mingled with non-trust funds; it presumes that any withdrawals are made first against the non-trust funds …'.

[61] See Duggan (n 58) 212–14.

[62] *Hannan* (n 37).

[63] Ibid 186 [26] (citations omitted).

However, there are instances where it may be possible to apply the original LIBR to cases where the funds of multiple beneficiaries have been commingled in the same account. For example, B1 posts $10 on day 1; T misappropriates $5 on day 2; B2 posts $10 on day 3; T files for bankruptcy on day 4, leaving $15 in the account. If the LIBR is applied, B1 can claim $5 and B2 can claim $10 provided that there are accurate records of the transactions into and out of the account. Consequently, the original LIBR can be applied in cases where there is more than one beneficiary, provided that the beneficiaries do not experience a simultaneous loss and there are accurate records.[64]

C *The Shortcomings of the LIBR*

First, the LIBR has often been rejected in cases where there are multiple transactions over a prolonged period because the rule requires not only a consideration of the amount deposited by each individual beneficiary and the timing of each deposit, but also a consideration of the lowest balance in the account after a shortfall occurs.[65] This rule requires accurate account records in order to analyse the timing of each shortfall. It will be hard or impossible to apply this rule in situations where the records of deposits and withdrawals into the account are incomplete or inaccurate. The more beneficiaries or transactions that are involved, the less likely it is that the LIBR will be effective in providing a solution.

Second, the LIBR does not help a beneficiary in a situation where the trust funds in the account have been completely depleted or the account has gone into overdraft. This is known as the nil balance rule ('NBR'). For example, if B provides T with $20 to deposit in a trust account, and T later misappropriates the $20 and leaves $0 in the account, there is nothing left in the account for B to claim. Barkehall Thomas has written that '[a]lthough the LIBR and the NBR are frequently treated as separate rules, it appears that they have a common explanation'.[66] Therefore, the LIBR and the NBR are two sides of the same coin. Barkehall Thomas has also explained the logic behind the rule:

> Both the LIBR and the NBR follow the identical premise that once some or all of the money has been withdrawn from the trust account and dissipated, the

[64] This was confirmed by Campbell J in *Re Sutherland* (n 43), who held that the LIBR could be applied to resolve disputes among competing classes of beneficiaries if there is sufficient evidence to perform the calculations: at 420–1 [187].

[65] See, eg, *Letten* (n 34). See above nn 39–43 and accompanying text.

[66] Barkehall Thomas, 'Tracing' (n 38) 96 (citations omitted).

plaintiff's money, or, to be more accurate, the plaintiff's right to part of the chose in action, as an identifiable part of that account has disappeared. Once the property has gone, tracing is useless. A withdrawal which reduces the credit balance also reduces the ability of the beneficiary to identify his or her funds as remaining in the account. A withdrawal that places the account into overdraft results in all identifiable property disappearing from the account.

Logically, when an account has reached a nil balance or is overdrawn, the facts are merely an extension of the lowest intermediate balance rule.[67]

D *The Rule in* Re Hallett's Estate

In order to mitigate the potential harsh consequences of the NBR for beneficiaries, courts in Australia have followed the tracing presumption introduced in the English authority of *Re Hallett's Estate; Knatchbull v Hallett* ('*Re Hallett's Estate*').[68] The presumption 'provides that where a beneficiary's funds are paid into a bank account and mixed with a trustee's funds, the trustee will be presumed to have withdrawn his or her funds first, thereby leaving the balance for the beneficiary'.[69] This tracing presumption was designed for the benefit of a beneficiary in situations where a trustee has commingled its own personal funds with the trust funds of the beneficiary in the trustee's own personal account or the trust account, and there is a shortfall of trust funds on the date of the trustee's bankruptcy.

For example, B provides T with $20 to deposit into a trust account on day 1; however, T deposits the $20 instead into its personal bank account, which already has $10. On day 2, T makes an unauthorised withdrawal of $15 from the account. On day 3, T declares bankruptcy, leaving $15 in the account. It is presumed under the rule in *Re Hallett's Estate* that the withdrawal of $15 first comprised $10 of the trustee's personal funds in combination with $5 the of beneficiary's funds. Consequently, the rule will allocate the remaining $15 to the beneficiary. The trustee is not allowed to argue that the unauthorised withdrawal of $15 was comprised only of the beneficiary's funds and that any of the funds remaining in the trustee's personal account belong to the trustee (or the trustee's estate).

[67] Ibid.

[68] (1880) 13 Ch D 696 ('*Re Hallett's Estate*').

[69] Matthew Broderick, 'Tracing under the PPSA' (2014) 32(6) *Company and Securities Law Journal* 379, 384.

E *The Overdraft Problem and the Distinguishable Fund Theory*

Although it will not be typical for a trust account to have an overdraft facility, this type of facility may be available to the trustee for its own personal account. The NBR and the LIBR present an additional problem for a beneficiary whose funds have been wrongfully commingled by the trustee in its own personal account and the account was in, or has gone into, overdraft; these rules will defeat the beneficiary's ability to trace the misappropriated trust funds. The orthodox position that prohibits tracing into an overdrawn bank account is the result of treating the deposits in a bank account as a 'distinguishable fund' (as opposed to a 'blended fund'). The 'distinguishable fund' theory suggests that 'individual deposits *retain* their identity in the increased balance. The balance is seen as composed of a series of debts … withdrawals can be ascribed to particular deposits'.[70] Broderick has explained that 'where an account containing a beneficiary's funds becomes overdrawn, or funds are paid into an overdrawn account to reduce its balance, a tracing claim will fail because the funds can no longer be *identified* as property'.[71]

The NBR, the LIBR, and the Hybrid Rule (which incorporates the LIBR) will prevent a beneficiary from tracing and claiming any trust funds in an account in a situation where the account has gone into overdraft and then has been brought back into credit with other funds.[72] Any subsequent deposits that are made to bring the account out of overdraft do not have a link with the trust funds that were previously misappropriated and cannot be identified as the trust property that was misappropriated.

For example, on day 1, B provides T with $10 to deposit in a trust account, which T deposits instead in its personal bank account; on day 2, T makes an unauthorised withdrawal of $15 in the account by drawing on an overdraft facility; on day 3, T deposits $10 of its own personal funds into the account; on day 4, T declares bankruptcy, leaving a credit of $5 in the account.

A strict application of the NBR and the LIBR means that the beneficiary will not be able to trace their $10 into the account because this trust property has left the account, since the trustee withdrew $10 of the beneficiary's funds and drew $5 on the overdraft facility on day 2. As will be explained below, whether the beneficiary will be able to claim the $5 remaining in the account, which is comprised of the trustee's personal funds, will depend on which replenishment theory is adopted in the beneficiary's jurisdiction.

70 Smith, *The Law of Tracing* (n 15) 185 (emphasis in original).

71 Broderick (n 69) 385 (emphasis added).

72 See *Letten* (n 34) 123 [291] (Gordon J).

F *Replenishing Trust Funds*

A strict application of the NBR and the LIBR can produce harsh results for beneficiaries in situations where the trustee has replenished funds in the commingled account with its own personal funds so that there is no longer a shortfall in the account, as occurred in *James Roscoe*.[73] For example, on day 1, B provides T with $20 to deposit into a trust account, which T deposits instead into its personal bank account, which already has $10; on day 2, T makes an unauthorised withdrawal of $15 from the account, leaving $15 in the account; on day 3, T deposits $5 of its own personal funds into the account and then declares bankruptcy, leaving $20 in the account.

There are two schools of thought with respect to situations where the trustee uses its personal funds to replenish a shortfall. The first school of thought (the 'actual intention approach') adopts a strict application of the LIBR and argues that there is only an exception to the LIBR in cases where the trustee manifests an 'actual intention' to replenish the misappropriated trust funds by depositing its own personal funds into the account. In those cases, the trustee's personal funds would serve to replenish the shortfall in trust funds and would become trust funds. If the trustee has not manifested an intention to replenish the shortfall in trust funds with its own personal funds, a strict application of the LIBR means that the beneficiary will only be allowed to claim $15, as this was the lowest balance of trust funds recorded in the account. The remaining $5 comprises the trustee's personal funds, and thus will be distributed by the liquidator to the trustee's unsecured creditors.

Professor Duggan has written that courts have strictly applied the LIBR in order to protect the trustee's unsecured creditors:

> [T]he tracing issue typically arises where the trustee is insolvent so that the beneficiary's claim on the account is in competition, not with the trustee himself, but with the claims of the trustee's unsecured creditors. The lowest intermediate balance rule aims to prevent the beneficiary's tracing rights from encroaching too far on the rights of unsecured creditors.[74]

The actual intention approach arguably provides more protection to the trustee's unsecured creditors because the trustee will not always manifest an actual intention to replenish the shortfall in trust funds with a deposit of its own funds. As noted in the example above, the remaining $5 will be distribut-

[73] *James Roscoe* (n 50) 63.

[74] Duggan (n 58) 214, citing Richard Calnan, *Proprietary Rights and Insolvency* (Oxford University Press, 2nd ed, 2016) 332 [8.151], 343 [8.196].

ed by the trustee's liquidator to the trustee's other unsecured creditors. This does not mean, however, that B is left without a remedy. If B is unable to trace the misappropriated $5 outside of the account to other sources, B will still be able to claim a pro-rata share of the trustee's remaining assets as an unsecured creditor.

This school of thought has been followed by courts in Australia[75] and in some other common law jurisdictions.[76] For example, the California Court of Appeal in *Chrysler Credit Corporation v The Superior Court of Contra Costa County* ('*Chrysler Credit*')[77] held that the exception to the LIBR was 'properly limited to contests between trustee and beneficiary, where the trustee essentially embezzles trust funds and subsequently *intends* to, and does, replace them'.[78] Broderick has also noted that

> [t]he general law of tracing in Australia *does not invoke a presumption* that payments by a defaulting fiduciary, which replenish a depleted account, restore a beneficiary's funds, although if legitimate deposits were *intended* for a beneficiary this would suffice as an intention to supplement the funds in the account.[79]

The second school of thought (the 'presumed intention approach') argues that there is an exception to the LIBR in cases where the trustee replenishes a

[75] See, eg, *Re Sutherland* (n 43) 417–18 [175] (Campbell J).

[76] Kandestin has noted that the US cases of *Re Amp'd Mobile Inc; Asurion Insurance Services Inc v Amp'd Mobile Inc*, 377 BR 478, 489–90 [12]–[14] (Shannon J) (Bankr D Del, 2007) and *Re Catholic Diocese of Wilmington; Official Committee of Unsecured Creditors v Catholic Diocese of Wilmington Inc*, 432 BR 135, 149–51 [8]–[11] (Sontchi J) (Bankr D Del, 2010) followed the actual intention approach:

> To alleviate this difficulty, trust law employs a fiction known as the 'lowest intermediate balance test', which holds that whenever a trustee withdraws money from a commingled account, the trustee withdraws non-trust-fund dollars first, thereby maintaining as much of the trust fund as possible. But any funds added by the trustee to the account are treated as non-trust funds, so if an account is depleted to $0 and then replenished (as may commonly occur when a bank account is swept to $0 by the debtor's lender), the trust funds are lost and the constructive trust claim is defeated. Many Delaware courts apply this approach to deny trust claims seeking to reach commingled money in accounts whose balances were replenished after having fallen …

Cory D Kandestin, 'Tracing Del Bankruptcy Court's Unclear Tracing Rules', *Delaware Business Court Insider* (Web Page, 22 May 2013) <https://www.law.com/delbizcourt/almID/1202601203086/tracing-del-bankruptcy-courts-unclear-tracing-rules/>, archived at <https://perma.cc/N6QP-KVFZ>.

[77] 17 Cal App 4th 1303 (1993) ('*Chrysler Credit*').

[78] Ibid 1317 (Stein J, Strankman PJ and Dossee J agreeing at 1318) (emphasis added).

[79] Broderick (n 69) 385 (emphasis added) (citations omitted).

shortfall by depositing its own personal funds into the account because there is a legal presumption that the trustee intends to reimburse the trust funds. This presumption applies in cases where the trustee misappropriated the trust funds, or the loss occurred due to some other operational risk. Under this approach, the $20 remaining in the account should be distributed in its entirety to the beneficiary.

The Court in *Chrysler Credit* explained the presumption as follows:

> It has been held that where a trustee commingles personal funds with trust funds, and dissipates the commingled funds such that the trust funds are affected, and then deposits additional personal funds into the account, it may be *presumed* that the trustee was *intending* to reimburse the trust funds. In such a situation, the trust funds will be replenished.[80]

These comments notwithstanding, the judges in that decision refused to accept the presumption as an exception to the LIBR because they believed that 'this exception, if broadly applied, would completely emasculate the rule'.[81]

There is currently a split of authorities in the US; some courts have followed the 'presumed intention' school of thought.[82] For example, in *Re Mahan & Rowsey Inc; Turley v Mahan & Rowsey Inc* ('*Re Mahan*'),[83] Berry J held that:

> Where a trustee commingles his beneficiary's money with his own, and then invades the common store, he will be presumed to have used his own money first — the law presumes that he does right rather than wrong … The converse should therefore be true. When a trustee replenishes a commingled account which has fallen below the amount held in trust due to the trustee's invasion, the trustee is *presumed* to return the beneficiary's money first.[84]

Stoddard has noted that the 'presumed intention' exception to the LIBR 'is indeed groundbreaking for this inquiry. It allows some of the rigidity of an

80 *Chrysler Credit* (n 77) 1317 (Stein J) (emphasis added).

81 Ibid.

82 See, eg, *Mitchell v Dunn,* 211 Cal 129, 134 (Waste CJ) (1930); *Church v Bailey*, 90 Cal App 2d 501, 504 (McComb J) (1949); *Re California Trade Technical Schools Inc; Kupetz v United States*, 923 F 2d 641, 646 [9]–[10] (Reinhardt J) (9th Cir, 1991).

83 *Re Mahan* (n 34).

84 Ibid 904 [10]–[11] (emphasis added). This approach was also followed in *Re Mazon; Mazon v Tardif*, 387 BR 641, 646 [7]–[9] (Steele J) (MD Fla, 2008). See generally Melissa Davis, 'Tracing Commingled Funds in Fraud Cases', *American Bankruptcy Institute* (Web Page, July 2017) <https://insolvencyintel.abi.org/bankruptcyarticles/tracing-commingled-funds-in-fraud-cases>, archived at <https://perma.cc/SKR5-PPEN>.

important rule to flex in a situation where it would be equitable to do so, depending on the facts of a case.'[85]

1 *Which Approach Should Courts Adopt?*

It is argued that the presumed intention approach should be followed in Australia and in other common law jurisdictions for two main reasons. First, the first school of thought should be criticised for considering the actual intention of the trustee. In many cases the trustee will not manifest any kind of intention when they make the wrongful withdrawal of trust funds from the account. Any evidence provided *post factum* by the trustee about its actual intention during the time of misappropriation should be considered irrelevant or unreliable. For instance, the intention of the trustee will be irrelevant in situations where the trustee erroneously caused a shortfall and then remedied the situation by depositing its own funds in the account. Also, the intention of the trustee will be unreliable in situations where the trustee was running a Ponzi scheme or had fraudulently misappropriated trust funds. The court should therefore always presume that the trustee intended to replenish a shortfall in a commingled trust account in situations where the trustee has replenished the account with its own personal funds.

Second, whereas the presumed intention approach always protects the beneficiaries by presuming that a deposit of trustee's personal funds replenishes a shortfall, the actual intention approach protects the trustee's unsecured creditors in situations where the trustee has not manifested an intention to replenish a shortfall. However, it is argued that it is preferable, as a matter of policy, to protect beneficiaries over the trustee's unsecured creditors because the trustee is in a fiduciary relationship vis-à-vis the beneficiaries; therefore, the trustee owes the beneficiaries a fiduciary duty to protect their trust property. The trustee is only in a debtor–creditor relationship with the unsecured creditors, who only have a personal claim against the property of the trustee.

Furthermore, whereas unsecured creditors could take action to protect themselves from the trustee's credit risk by negotiating with the trustee to obtain a security interest over the trustee's personal property, beneficiaries are not usually in a position to increase their protection unless they purchase insurance, as they already have a proprietary interest in the trust property. It is argued that courts in Australia should protect the trust beneficiaries at the expense of the trustee's unsecured creditors by presuming that the trustee

85 Stoddard (n 26) 159 (citations omitted).

always intends to replenish a shortfall of trust funds in situations where it has deposited its own personal funds into the account. Accordingly, these funds should become trust funds and be distributed to the beneficiaries by the trustee's liquidator.

The presumed intention approach is flexible and works in situations where a trustee has wrongfully commingled its own trust funds with those of a single beneficiary or multiple beneficiaries in either a trust account or the trustee's personal bank account. This approach works in combination with the Hybrid Rule where the funds of multiple beneficiaries have been commingled. This approach is also compatible with Cutts' theory of intentional transactions,[86] as it can be deduced from the agreement as a whole that the parties intended from the beginning of the arrangement for the trustee to replenish any subsequent shortfalls. This approach also works in situations where the trustee depletes the funds in the account, draws on an overdraft facility, and then replenishes the account to leave a credit balance comprised of the trustee's personal funds.

For example, on day 1, B provides T with $10, which T deposits in its personal bank account; on day 2, T makes an unauthorised withdrawal of $15 from the account by drawing on an overdraft facility; on day 3, T deposits $10 of its personal funds into the account; on day 4, T declares bankruptcy, leaving a credit of $5 in the account. According to the presumed intention approach, it is presumed that the trustee intended to replenish the account in order to reduce the shortfall of trust funds. As a result, this approach permits the beneficiary to trace and claim the remaining $5 in the account.

G *Does the Blended Fund Theory Provide a Solution to the Overdraft Problem?*

The 'blended fund' theory views a cash account as an '*indistinguishable mixture of value*, and so it is impossible to say which part is any claimant's';[87] the 'individual deposits *lose* their *identity* in the increased balance. The result of the loss of identity of deposits is that withdrawals cannot be definitively ascribed to any particular deposit.'[88] A blended fund arises if the beneficiaries opt to hold their trust funds in an omnibus account (ie a mixed fund) as co-owners. It also automatically arises if accurate transaction records are not

[86] See above nn 22–3.

[87] Smith, *The Law of Tracing* (n 15) 195 (emphasis added).

[88] Ibid 185 (emphasis added).

kept. In these situations, the court must apply a basic pro-rata approach to distribute funds in the mixed fund to the beneficiaries.

Barkehall Thomas argues that courts and liquidators do not have to concern themselves with the intention of the trustee or whether the account went into overdraft if courts treat a commingled account as a 'common pool' and a 'blended account':

> [I]f there is a true common pool, there is no need to continue to try to identify individual plaintiffs' funds in the account. The acceptance of the common pool necessitates an acceptance of the impossibility of sorting one person's money from another's.
>
> On that basis, it is inappropriate to continue to apply the nil balance rule. This is a rule which attempts to sort one plaintiff's money from another's, and it has no place once individual property rights can no longer be recognised. …
>
> … If the nil balance rule is merely a logical extension of the LIBR, there is no warrant for treating beneficiaries differently inter se when the balance is $1 in positive as compared to $1 negative. If the account balance reduces to $1 positive, but the blended fund approach applies, later contributions enable earlier beneficiaries to retain their full proportional entitlements. In effect, any *intermediate* balance is irrelevant. If that is the case, it is logically inconsistent to deny earlier beneficiaries their rights to contribute in a division of the fund if, at some point, it went $1 into overdraft.[89]

Barkehall Thomas argues that courts can get around the shortcomings of the NBR, the LIBR, and the burden of having to determine the trustee's intention in a replenishment situation by ignoring the order of deposits and withdrawal of funds into the account (whether trust funds or the trustee's personal funds) and applying the pro-rata approach in a shortfall situation.[90] She argues that 'a mixed fund should be treated as a "blended fund" in which individual rights to trace are lost once money is deposited into a mixed account'.[91] This position 'would be attractive to those who view all plaintiffs as victims of a common misfortune. It is a view of the "common pool" solution that adopts broad notions of fairness and justice.'[92]

[89] Barkehall Thomas, 'Tracing' (n 38) 98–101 (emphasis in original).

[90] Ibid.

[91] Barkehall Thomas, 'Common Pool Exception' (n 27) 190 n 49, citing ibid 102.

[92] Barkehall Thomas, 'Tracing' (n 38) 99.

However, it is argued — contrary to Barkehall Thomas' view — that the Hybrid Rule (which incorporates the NBR and the LIBR) is superior to the pro-rata approach. It is possible to overcome the shortcomings of the NBR, the LIBR, and the Hybrid Rule by adopting the presumed intention approach so that beneficiaries are not left without the ability to trace trust funds into the account in situations where the trust account has been reduced or gone into overdraft and the trustee has replenished the account with its personal funds.

V The LIBR–Pro-Rata Hybrid Rule

As mentioned above, a major drawback of the original LIBR is that it may not be possible to allocate the loss of a defalcation to a specific beneficiary in cases where there are multiple beneficiaries.[93] McLure J in *Re Global Finance Group Pty Ltd (in liq); Ex parte Read* ('*Re Global Finance*')[94] noted that 'no authority has ever applied the lowest intermediate balance rule in circumstances involving rival claims of trust beneficiaries'.[95] Consequently, courts in common law countries have improvised and developed the Hybrid Rule (also referred to as the 'fund unit allocation' model and 'pro-rata on the basis of tracing')[96] which combines the LIBR with the pro-rata rule for situations where the trust funds of multiple beneficiaries are commingled in the same account — in other words, for resolving beneficiary–beneficiary disputes.[97] It also applies where the trustee wrongfully commingles its own personal funds with the funds of multiple beneficiaries (beneficiary–beneficiary–trustee disputes).

For example, B1 and B2 each deposit \$100 with T on day 1; T misappropriates \$100 on day 2; T becomes bankrupt on day 3. The lowest intermediate balance in the account for B1 and B2 was \$100. However, as it is not possible to know which beneficiary's funds were misappropriated by the trustee and

93 See above Part IV(C).

94 *Re Global Finance* (n 2).

95 Ibid 410 [116].

96 Stoddard has distinguished between the original LIBR and the hybrid version of the LIBR:

> (a) the *lowest intermediate balance rule* (LIBR), adopted from trust accounting, which is currently the mainstay of secured transactions tracing; (b) the *pro-rata distribution hybrid of the lowest intermediate balance rule*, used in more complicated commingling cases, where multiple trust funds are mingled … especially in cases with multiple creditors.

Stoddard (n 26) 138, 144 (emphasis in original).

97 Duggan (n 58) has noted that the Hybrid Rule applies to beneficiary–beneficiary disputes: at 214–15.

whose funds remain in the account, the loss is allocated on a pro-rata basis to both B1 and B2. As a result, B1 and B2 can each claim $50 in the account. B1 and B2 may also be able to trace the misappropriated $100 out of the account.

In order to work properly, the Hybrid Rule requires an accurate ledger with a record of transactions that have occurred in the relevant account. It is stressed that courts cannot apply the Hybrid Rule in situations where the account records are incomplete, inaccurate, or require significant reconstruction. For example, Gordon J in *Letten* held that it was inappropriate to apply the Hybrid Rule because it would be too complex and costly to reconstruct accounts after the trustee made several unauthorised withdrawals.[98] In those cases, courts will have to apply the pro-rata approach.

A *The Mechanics of the Hybrid Rule*

The mechanics of the LIBR–pro-rata hybrid rule have never been fully explained, which has created legal uncertainty. It is not surprising that Barkehall Thomas has written that 'there appears to be no practical difference between the "rolling charge" solution and the effect of applying the LIBR to a multiple beneficiary case. There is, however, no real case which exists and which demonstrates this.'[99]

Kinsey and Papaelia have identified two different versions of the Hybrid Rule.[100] The first version (the 'claims' version)

> provides that tracing into a mixed fund cannot occur for any sum that exceeds the lowest balance in the fund during the interval between the time of the original contribution and *the time of a claim* to that contribution … LIBR is not a separate rule of tracing but is applied by the courts in conjunction with the *rateable approach*.[101]

The second version (the 'rolling charge' or 'North American' version)

> provides that a withdrawal from a mixed fund is allocated in the *same proportions* as the different beneficiaries bear to each other at the moment before the

[98] *Letten* (n 34) 123 [292].

[99] Barkehall Thomas, 'Tracing' (n 38) 98.

[100] Kinsey and Papaelia (n 35) 267–8.

[101] Ibid (emphasis added) (citations omitted).

> withdrawal is made. In other words, each debit to the fund is attributed *to all existing claimants at the relevant time* on a *pro-rata* basis.[102]

Therefore, both definitions describe the Hybrid Rule, as the methods both combine the LIBR and the pro-rata approach.

There is a subtle yet important difference between these two versions of the Hybrid Rule which affects the final distribution of trust funds to the beneficiaries. The first version applies the LIBR as each misappropriation occurs in the account, but it does not apportion the losses on a pro-rata basis to the entire group of beneficiaries until the time that the scheme is wound up and the beneficiaries *claim* their remaining funds.

The second version applies the LIBR and pro-ratas the losses as each misappropriation occurs in the account so that the beneficiaries that had funds in the account at the time of a defalcation experience a proportionate and simultaneous loss as a group. First, this version requires a consideration of the amount deposited by each individual claimant, the timing of such deposits, and a consideration of the *lowest balance* in the client account after the shortfall occurred. This involves analysing the pattern and timing of each shortfall and applying the results to each individual deposit (the LIBR step). Second, it allocates losses on a pro-rata basis among those beneficiaries that had trust funds deposited with the trustee at the time the shortfall occurred (the pro-rata step). Any subsequent deposits into the account by new or existing beneficiaries are unaffected until the account experiences another shortfall.

The different outcomes of these two versions of the Hybrid Rule can be seen in the following example.[103] B1 deposits $60 with T on day 1; T misappropriates $30 on day 2; B2 deposits $60 with T on day 3; T misappropriates $30 on day 4; B3 deposits $60 on day 5; T misappropriates $30 and then declares bankruptcy on day 6, leaving $90 in the account.

The first version of the Hybrid Rule looks at the lowest intermediate balance for each beneficiary over the course of all the transactions that take place in the account. This means that B1 can claim a maximum amount of $30,[104] and B2 and B3 can each claim $60,[105] as these were the lowest balances that were reached whilst each respective beneficiary had funds in the account.

[102] Ibid 268 (emphasis added) (citations omitted).

[103] For a similar example, see ibid 268–9.

[104] The account balance reaches a low of $30 on day 2, which only affects B1.

[105] The account balance never falls below $60 after B2 and B3 deposit their funds; therefore, B2's and B3's claims are not affected by the LIBR in this case.

However, since the remaining amount of $90 in the account is insufficient to meet the collective claims of $150 of the beneficiaries after the LIBR has been applied,[106] each beneficiary's claim is pro-rataed to reflect the shortfall in the account; consequently, on the distribution date, B1 will receive $18,[107] and B2 and B3 will each receive $36 of the remaining $90.[108]

The calculations for the second version are slightly more complex, as both the LIBR and the pro-rata rule are applied after each defalcation. On day 1, B1 has a claim of $60. On day 2, B1 has a claim of $30, as $30 has been misappropriated. On day 3, B1 has a 1/3 claim ($30) and B2 has a 2/3 claim ($60) out of the $90 in the account. On day 4, B1 has a 1/3 claim ($20) and B2 has a 2/3 claim ($40) out of the $60 in the account. On day 5, B1 has a 1/6 claim ($20), B2 has a 2/6 claim ($40), and B3 has a 3/6 claim ($60) out of the $120 in the account. On day 6, B1 has a 1/6 claim ($15), B2 has a 2/6 claim ($30), and B3 has a 3/6 claim ($45) out of the $90 remaining in the account. As a result, B1 will receive $15, B2 will receive $30, and B3 will receive $45.[109]

1 *Which Version Is Preferable?*

The North American version of the Hybrid Rule imposes heavier losses on beneficiaries who deposited trust funds earlier in the account than the claims version. Consequently, the North American version is the preferred fictional rule because it more accurately reflects that earlier beneficiaries will have lost their property rights, leaving them unable to identify their trust funds and trace into the account.

It is arguably fairer to shift the losses onto earlier investors than onto later investors because beneficiaries who deposited funds earlier are potentially in a better position than newer beneficiaries to verify the legitimacy of the transactions and investments being made by the trustee. There should be a longer paper trail and a better opportunity for a beneficiary who has had extended dealings with the trustee to uncover any wrongdoing committed by the trustee. In other words, beneficiaries who have a longstanding engagement with the trustee have an opportunity to follow up with the trustee and

106 B1 can claim $30, whereas B2 and B3 can each claim $60.

107 B1's claim of $30 is reflected as a percentage of the total claims ($30 \div 150 = 0.2$, or 20%). Since B1 has 20% of the total claims available, B1 will be able to claim 20% of the remaining funds in the account ($90 \times 0.2 = 18$).

108 B2's and B3's respective claims of $60 are reflected as a percentage of the total claims ($60 \div 150 = 0.4$, or 40%). Since B2 and B3 each have 40% of the total claims available, B2 and B3 will each be able to claim 40% of the remaining funds in the account ($90 \times 0.4 = 36$).

109 For the sake of comparison, if the basic pro-rata approach were applied to these facts, each beneficiary would receive $30.

ask for evidence of how the trustee has been managing their trust funds.[110] This opportunity to uncover wrongdoing may not be available to beneficiaries who have only engaged with the trustee for a short period of time.

It is arguably for these reasons that courts in Canada[111] and the US[112] have adopted the North American version of the Hybrid Rule. Kinsey and Papaelia have reported that they 'are not aware of any cases in which a court has applied the rolling charge model in Australia'.[113] Nevertheless, Campbell J in *Re Sutherland* held that '[although] when a depletion occurs from a fund, it is the fund as a whole, as it exists at that time, which is depleted, accretions to the fund after that time are, self-evidently, not affected by that depletion'.[114] This appears to support the North American version of the Hybrid Rule. Courts in Australia should therefore be able to adopt and apply the North American version of the Hybrid Rule as the general rule where the beneficiaries have not clearly expressed an intention as to how they would like to allocate risk and hold their funds in the commingled account.

B *Reception of the Hybrid Rule in Australia*

The pro-rata approach has apparently been favoured over the Hybrid Rule by academics and courts in Australia. For instance, McMillan J in *Hannan* noted that '[t]he "North American model" or "rolling charge rule" … has not found favour in Australia'.[115] The tilt in favour of the pro-rata approach in Australia was influenced by the dictum in the Canadian case of *Law Society of Upper Canada v Toronto-Dominion Bank* ('*LSUC*'),[116] which favoured the pro-rata approach over the Hybrid Rule as the general rule for allocating a shortfall in a mixed fund. Unfortunately, some Australian courts were persuaded to

[110] It is acknowledged that this approach is problematic, as the trustee may provide the beneficiary investors with fraudulent statements, thereby making it harder for them to uncover a fraudulent scheme. Nevertheless, earlier investors are arguably still in a better position to investigate potential wrongdoing than later investors.

[111] Morawetz J in *Boughner* (n 31) provided an example explaining the mechanics of the Hybrid Rule: at 702–3 [4]–[5].

[112] See, eg, *Gibbs v Gerberich*, 203 NE 2d 851, 856 (Doyle J, Hunsicker PJ and Stevens J agreeing at 856) (Ohio Ct App, 1964) ('*Gibbs*').

[113] Kinsey and Papaelia (n 35) 268.

[114] *Re Sutherland* (n 43) 421–2 [192].

[115] *Hannan* (n 37) 186 [27] (citations omitted).

[116] *LSUC* (n 58). For more information on Canadian case law, see generally Chamorro-Courtland, 'Demystifying the LIBR' (n 5).

follow this dictum.[117] Barkehall Thomas has also rejected the Hybrid Rule and argued that

> despite the fact that the 'rolling charge' solution is frequently touted as the North American alternative, it would actually be unlikely for it to be adopted in an American case involving multiple victims of a common fraud. The pari passu solution is preferred. It appears as though the rolling charge solution has never been applied in Australia or England, on the basis that it is too complex or impractical.[118]

However, the recent approach adopted by some Canadian courts for allocating shortfalls can serve as a guide for the development of Australian law. The Hybrid Rule has recently been revived as the general rule in Canada. Courts have shifted away from the *LSUC* decision and followed the Ontario Court of Appeal decision in *Re Ontario Securities Commission and Greymac Credit Corp* ('*Greymac*'),[119] which was approved by the Supreme Court of Canada.[120] In *Greymac*, Morden JA held that the Hybrid Rule is the general rule for distribution where there are accurate and complete records and the funds can be identified and traced:

> I am not persuaded that considerations of possible inconvenience or unworkability should stand in the way of the acceptance, as a *general rule*, of *pro-rata sharing on the basis of tracing*. That it is sufficiently workable to be the *general rule* is indicated by the fact that it appears to be the majority rule in the United States …[121]

For instance, the Ontario Superior Court decision of *Boughner* more recently followed the *Greymac* decision.[122] Morawetz J held that the Hybrid Rule was the most 'just and equitable' method for distributing the remaining funds on the facts of the case.[123] In this case, there was evidence that the early investors had lost over 88% of their investment value due to the fraudulent misappropriations of the trustee. Morawetz J held that it was not fair to apply the prorata approach and have the later investors subsidise the losses of the earlier

[117] See, eg, *Hannan* (n 37) 187–9 [33]–[36] (McMillan J).

[118] Barkehall Thomas, 'Common Pool Exception' (n 27) 181 (citations omitted).

[119] *Greymac* (n 34).

[120] *Greymac Trust Co v Ontario Securities Commission* [1988] 2 SCR 172.

[121] *Greymac* (n 34) 17 (emphasis added).

[122] *Boughner* (n 31).

[123] Ibid 719 [91].

investors.[124] His Honour approved of the submission that '[j]ust as earlier investors would not have expected to share their gains with later investors, they should not be allowed to so share their losses'.[125] Morawetz J agreed with Morden JA's dictum in *Greymac* that the Hybrid Rule is the 'general rule' to be applied in a shortfall situation, unless it is unworkable.[126]

Morawetz J also held that the pro-rata distribution method is the exception and should only be used where it is 'practically impossible'[127] to trace or too expensive and time-consuming to make the necessary calculations to apply the Hybrid Rule.[128] As noted by Duggan, after the legal uncertainty created by the *LSUC* decision over the applicability of the Hybrid Rule in Canada, the *Boughner* decision resulted in a 'return to normalcy'.[129]

In *Easy Loan Corporation v Wiseman* ('*Easy Loan*'),[130] the Alberta Court of Appeal recently followed the dictum in *Boughner* and agreed that the

> LIBR [Hybrid Rule] is the general rule for allocating funds among innocent beneficiaries when there is a shortfall … There are two exceptions: LIBR is unworkable or the beneficiaries expressly or impliedly intended another method of distribution.[131]

The Justices of Appeal agreed that 'there appears to be little doubt that LIBR (even if not applied) is the fairest rule but also the most difficult to apply in practice because of the detailed calculations it requires'.[132] They also agreed that the dictum of Morden JA in *Greymac* supported the Hybrid Rule as the 'general rule' with the exception of cases where 'the claimants expressly or by implication intended to distribute on some other basis'.[133]

In line with the trend in Canada and the US, it is argued that the Australian courts should also adopt the North American version of the Hybrid Rule as the general rule for distributing trust funds in a shortfall situation when the express or implied intention of the beneficiaries is unclear.

124 Ibid 719–20 [92], 720 [95].

125 Ibid 712 [56].

126 Ibid 719 [89].

127 Ibid.

128 See generally ibid 719–20 [89]–[94].

129 Duggan (n 58) 210.

130 [2017] ABCA 58 ('*Easy Loan*').

131 Ibid [57] (Berger, Rowbotham and McDonald JJ).

132 Ibid [45].

133 Ibid [46], citing *Greymac* (n 34) 18 (Morden JA for the Court).

C *Guidelines for Applying the Hybrid Rule*

Smith has argued that the Hybrid Rule should be simple to apply in practice, provided that accurate electronic records are kept, as it requires no more than a modest computer and a short algorithm.[134] As long as it is not impossible to perform the calculations, '[i]nconvenience should not stand in the way of fairness'.[135] The case law has demonstrated, however, that many trust funds do not keep accurate records.[136] Nowadays, large trust funds have multiple beneficiaries and perform a multitude of simultaneous daily transactions. This may complicate the application of the Hybrid Rule if fraud is committed or records are not continuously updated.

Courts of equity have provided judges with a wide discretion to determine when it is considered too complex and inconvenient to trace and apply the Hybrid Rule in each case. Judges in Canada have a wide discretion to apply the pro-rata approach instead of the Hybrid Rule in situations where it is deemed too complex because there are many beneficiaries or many transactions in and out of the mixed fund. In order to restrict this discretion, Duggan has argued that 'the courts should rely on the qualification sparingly and resist the temptation to use [their discretion] as a vehicle for achieving result-based solutions'.[137]

As a guideline, judges should deem that it is too complex to apply the Hybrid Rule in situations where it costs more than around 20% of the remaining trust funds to conduct a tracing exercise.[138] In cases where the cost to conduct a tracing exercise exceeds 20% of the remaining trust funds, the pro-rata rule should be applied, as it would be unfair to all the beneficiaries if the remaining trust funds are expended so that the Hybrid Rule can be applied.

Nevertheless, as judges are applying equitable principles, the total amount that is expended on a tracing exercise should ultimately be at the discretion of the judge in each case; these figures could vary slightly depending on the facts

[134] Smith, *The Law of Tracing* (n 15) 268. The same argument was made by Parker ACJHC in the Ontario High Court of Justice: *Re Ontario Securities Commission and Greymac Credit Corp* (1985) 19 DLR (4th) 470, 498.

[135] *Easy Loan Corporation v Base Mortgage & Investments Ltd* [2016] ABQB 77, [71] (Yamauchi J).

[136] Accurate records might not be kept where the trustee commits fraud, where a large volume of daily transactions is performed, or where other operational risks have materialised.

[137] Duggan (n 58) 225 (citations omitted).

[138] A tracing exercise that consumes more than 20% of the remaining trust funds would be an unjustifiable waste of resources because the beneficiaries would receive significantly fewer funds.

of each case. This approach is preferable to adopting legislation that determines the maximum cost that can be expended in conducting a tracing exercise, as the discretionary approach provides the judge with some flexibility to minimise unfairness and maximise equity in each individual case.

VI The Intention-Based Approach

The intention-based approach applies the method of distribution expressly agreed to by the beneficiaries at the outset of the investment contract. In cases where their express intention is not clear, it is argued that there is a presumption that the beneficiaries intended to legally segregate their funds.

Courts in Australia have recognised the 'distribution according to intention' approach. Kinsey and Papaelia have written:

> One of the traditional approaches to tracing adopted by the courts has *focussed on the intention of the parties*. Under such an approach, the court will allocate funds deposited into a mixed fund, insofar as is possible, in accordance with the *parties' mutual intentions* (eg, as evidenced by an investment contract) …
>
> …
>
> In some instances, the court will also allocate funds in accordance with the *intentions of the trustee* even where that intention was not shared by the investor who contributed the funds.[139]

For instance, Santow J in *Australian Securities Commission v Buckley*[140] considered the intention of the beneficiaries when the trustee wrongfully commingled the funds of a group of beneficiaries who intended to keep their funds legally segregated with the funds of a second group of beneficiaries who intended to share the risk as co-owners in a common pool. Santow J was correct in considering the different intentions of the two groups of beneficiaries, as each group had accepted different levels of risk. His Honour permitted the beneficiaries who intended to legally segregate their funds to trace their funds into the account, and the group who intended to be co-owners to hold their funds in a common pool.[141]

In *Re Global Finance*, McLure J held that '[t]he *objectively determined intention* of the claimants at the outset of the relevant scheme can determine the appropriate method of distributing a mixed fund which is inadequate to meet

[139] Kinsey and Papaelia (n 35) 265–6 (emphasis added).

[140] (1996) 7 BPR 97615 (Supreme Court of New South Wales).

[141] Ibid.

all valid claims'.[142] As a result, courts can consider the objective (express) intention of the beneficiaries or the presumed intention of the beneficiaries in cases where the objective intention is not clear.

A *The Intention of the Trustee Is Irrelevant*

In *Re Stillman and Wilson*,[143] Clyne J held that courts should take into consideration the intention of the trustee when determining which method to use for allocating a shortfall.[144] McLure J also held in *Re Global Finance* that 'the trust account records reflect the trustee's contemporaneous intentions'.[145] It is argued, however, that courts should never consider or rely on the intention of the trustee. It would be unfair to the beneficiaries to allow a fraudulent or negligent trustee to determine which method of distribution is applied to allocate a shortfall among the beneficiaries who have borne losses in the mixed fund for unauthorised withdrawals, as will be explained below. The only intention that matters is the intention of the beneficiaries at the outset of providing the trustee with their trust funds.

B *Actual and Presumed Intention of the Beneficiaries*

The following section intends to provide a guide for courts in Australia to determine how to allocate a shortfall in situations where the beneficiaries have not expressed their intention. Barkehall Thomas has suggested that where all the beneficiaries have relied on the same publicity material upon investing with a particular trustee, 'they have all intended to be in the same position vis-à-vis each other'.[146] This suggests that there is a presumption that the beneficiaries intended to commingle their funds in a common pool as co-owners.[147] However, relying on the same publicity material, on its own, should not lead to a presumption that the beneficiaries intended to share risk as co-owners. It is possible to legally segregate and operationally commingle trust funds in an omnibus account. Courts should only find that a group of beneficiaries intended to share risk as co-owners in a situation where the

[142] *Re Global Finance* (n 2) 408 [107] (emphasis added), citing *Barlow Clowes* (n 36).

[143] (1950) 15 ABC 68 (Court of Bankruptcy).

[144] Ibid 72. This principle was approved in JD Heydon and MJ Leeming, *Jacobs' Law of Trusts in Australia* (LexisNexis Butterworths, 7th ed, 2006) 678 [2709].

[145] *Re Global Finance* (n 2) 424 [194].

[146] Barkehall Thomas, 'Common Pool Exception' (n 27) 190.

[147] Ibid.

beneficiaries expressed this intention in the relevant trust documentation or where the previous dealings between the parties demonstrate that they intended to share risk as co-owners.

Barkehall Thomas has correctly written that 'what the courts are really trying to do is determine the level of risk the beneficiaries thought they were accepting when they handed over their money'.[148] In order to make this determination, I have previously argued that

> consideration must first be given to the express or implied contractual *intention* of the beneficiaries in the case of a shortfall in a commingled trust fund; the beneficiaries may opt for any distribution method that satisfies their business needs.[149]

Consequently, if the contract is silent as to the method of distribution that should be used for allocating a shortfall, the presumption, as the general rule, should be that the beneficiaries intended to legally segregate and operationally commingle their funds in the omnibus account. This means that courts in Australia should apply the North American version of the Hybrid Rule for distributing funds in a shortfall situation. This presumption is justified, as it would be unfair to presume that a group of beneficiaries intended to share the risk of a shortfall in a commingled account as co-owners without prior knowledge or approval. This approach was followed in Canada by the Alberta Court of Appeal in *Easy Loan*.[150] This approach is also compatible with Morden JA's dictum in *Greymac*, who held that the Hybrid Rule is the general rule for distributing beneficiaries' funds, unless the beneficiaries have expressly or implicitly agreed to an alternative method for distribution.[151]

This presumption follows the regulatory trend in international financial markets towards protecting investor funds through legal segregation. In response to the global financial crisis, some jurisdictions introduced reforms to protect investor (beneficiary) funds from the insolvency of their brokers (trustees) by mandating legal segregation with operational commingling

148 Ibid 187.

149 Chamorro-Courtland, 'Demystifying the LIBR' (n 5) 66 (emphasis in original).

150 *Easy Loan* (n 130) [59]–[60] (Berger, Rowbotham and McDonald JJ).

151 *Greymac* (n 34) 18.

('LSOC').[152] This method permits trustees to deposit and commingle the funds of all beneficiaries into an omnibus account and treat the funds of each beneficiary as being legally segregated. This method reduces administrative burdens for the trustee and reduces costs for the beneficiaries, as the trustee only needs to deal with a single account instead of multiple accounts. However, the LSOC method requires the trustee to keep a detailed ledger for each beneficiary that is updated and accurately records the deposits and withdrawals from the commingled account.

Although Australia has not yet embraced the LSOC method, Velonis has argued that Australian financial markets should implement this approach in order to bring 'the Australian market in line with the reforms in other major jurisdictions' and to enhance the protection of funds deposited by investors with their brokers.[153] In support of this approach, courts of equity should follow the trend in financial markets in favour of legal segregation. This can be achieved by presuming that beneficiaries intended to legally segregate their funds in situations where they have commingled their trust funds in a single account and have not expressed a contrary intention.

The intention-based approach should be officially adopted as the main rule in Australia. This approach is workable in Australia under the current law because it is compatible with the dicta of McLure J in *Re Global Finance* and Campbell J in *Re Sutherland*. The Courts in these cases introduced flexibility and held that beneficiaries are not limited to a single tracing option. These cases also provide that courts will allocate a shortfall according to the express intention of the beneficiaries.

The intention-based approach requires courts to consider the intention of the beneficiaries as a group on a case-by-case basis. The court will usually be able to determine this intention from the language used in the trust documentation or from the previous course of dealings between the trustee and beneficiaries. This means that the beneficiaries can specifically request, in the trust documentation, that their funds be distributed by one of the methods outlined in this article. This approach is compatible with Cutts' intentional

[152] The US adopted the LSOC method to protect the funds of cleared swaps customers by amending the *Commodities Exchange Act*, 7 USC § 1 (1936) through the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub L No 111-203, § 724, 124 Stat 376, 1682–5 (2010). See generally Christian Chamorro-Courtland, 'Collateral Damage: The Legal and Regulatory Protections for Customer Margin in the US Derivatives Markets' (2016) 7(3) *William and Mary Business Law Review* 609.

[153] Adamantia Velonis, 'Protecting Client Collateral in the Australian OTC Derivatives Market: An Examination of the Relationship between Central Clearing, Account Structures and the Client Money Provisions' (2013) 21(3) *Insolvency Law Journal* 176, 178 (citations omitted).

transactions theory,[154] as courts can deduce the intention of the parties from looking at the agreement as a whole.

In cases where the beneficiaries have not mentioned a specific method of distribution, the court will need to determine from the documentation or from the previous course of dealings whether the beneficiaries intended to legally segregate their funds or whether they intended to share risk as co-owners. In cases where the beneficiaries have expressed an intention to legally segregate their funds, the court should apply the Hybrid Rule to allocate a shortfall. Conversely, in cases where the beneficiaries have expressed an intention to share the risk as co-owners, the court should apply the pro-rata approach to allocate a shortfall.

In practice, however, the case law has demonstrated that there are still cases coming before the courts where the intention of the beneficiaries is unclear. In those cases, courts can apply the methodology outlined in this article to determine the presumed intention of the beneficiaries. As the default rule, there should be a legal presumption that the beneficiaries intended to keep their funds legally segregated. This will permit courts to apply the Hybrid Rule to allocate a shortfall in situations where there are accurate account records. Alternatively, the court will need to apply the pro-rata approach to distribute a shortfall where it has become impossible to trace because accurate records have not been kept.

In order to avoid this uncertainty, trustees that operate an investment fund in Australia should have a fiduciary or statutory obligation to inform the beneficiaries of their options for holding trust funds before they make their first investments. The parties should clearly include this intention in the contract or trust deed to avoid the types of problems that are currently present in the case law. This process could be facilitated through the creation of standard form contracts which permit investors to opt for one of the various distribution methods before investing.

VII The Rule in *Clayton's Case*

The rule in *Clayton's Case* (also known as FIFO) states that the 'first withdrawals from an account are deemed to be made out of [the] first payments in'.[155] This means that withdrawals from a bank account extinguish the oldest deposits first, like a queue, where the first deposit in the queue is the first one

154 See above nn 22–3.

155 DA McConville, 'Tracing and the Rule in *Clayton's Case*' (1963) 79 (July) *Law Quarterly Review* 388, 388.

to be removed. For example, B1's, B2's, and B3's trust funds are commingled in a single trust account by T: B1 deposits \$100 on day 1; B2 deposits \$100 on day 2; B3 deposits \$100 on day 3; T misappropriates \$150 and declares bankruptcy on day 4. Under the rule in *Clayton's Case*, B1 receives nothing, B2 receives \$50, and B3 receives \$100.

This rule has been rejected in Australia,[156] Canada,[157] and the US[158] for situations where multiple beneficiaries are competing for trust funds in a commingled account that has a shortfall. The main reason that FIFO has been rejected in these jurisdictions is because it has the same shortcomings as the original LIBR.[159] The FIFO rule depends on the order of transactions and cannot assign losses in situations where several beneficiaries have invested money simultaneously in an omnibus account with the trustee, or where the order of the transactions cannot be determined because accurate records were not kept.

For example, if two beneficiaries each deposit \$100 into an omnibus account on Friday at 12:00pm, the rule in *Clayton's Case* cannot determine which beneficiary suffers the loss in the case of a subsequent unauthorised withdrawal and misappropriation by the trustee of \$100. For this reason, it appears that the rule in *Clayton's Case* has been rejected in Australia in favour of the pro-rata approach in cases where multiple beneficiaries experience a simultaneous loss in a mixed fund.[160]

[156] See, eg, *Keefe v Law Society of New South Wales* (1998) 44 NSWLR 451, 460–1 (Priestley JA, Sheller JA agreeing at 462, Powell JA agreeing at 462); *Re Jones (Deceased); Ex parte Mayne* (1953) 16 ABC 169, 174 (Clyne J) (Court of Bankruptcy); *Nelson* (n 33) 723 [24] (Austin J). See also *Re Global Finance* (n 2) 409 [112] (McLure J): 'The rule in *Clayton's Case* has also been strongly criticised in Australia and has not been applied in recent times by any Australian Court to the distribution of a mixed trust fund'.

[157] For example, the *Greymac* (n 34) decision rejected the rule in *Clayton's Case* for being 'unfair, arbitrary and based on a fiction': see *Boughner* (n 31) 717 [81] (Morawetz J), discussing *Greymac* (n 34) 15 (Morden JA for the Court).

[158] See, eg, *Gibbs* (n 112) 855–6 (Doyle J, Hunsicker PJ and Stevens J agreeing at 856).

[159] For other reasons on why courts have rejected the rule in *Clayton's Case*, see Chamorro-Courtland, 'Demystifying the LIBR' (n 5) 51–2.

[160] See, eg, *Nelson* (n 33), where Austin J observed that 'Australian authority has reached the point that *the rateable solution is to be preferred to the first in, first out approach where trust funds are mixed, without qualification*': at 723 [24] (emphasis added). This was approved by Campbell J in *Re Sutherland* (n 43) 413–14 [160].

A *Analysis*

As demonstrated in the example above, the rule in *Clayton's Case* works for allocating losses in situations where there are accurate records and where none of the beneficiaries suffer a simultaneous loss. As this rule on its own cannot allocate losses where multiple beneficiaries have experienced a simultaneous loss in a mixed fund, I propose creating a new FIFO–pro-rata hybrid rule in order to overcome the problems associated with the rule in *Clayton's Case*. This rule merges the FIFO rule with the pro-rata rule in order to allocate losses on the beneficiaries who deposited their funds at the same time.

For example, B1 and B2 each deposit \$50 with T on day 1; T misappropriates \$50 on day 2; B3 deposits \$50 with T on day 3; T misappropriates \$20 on day 4 and declares bankruptcy, leaving \$80 in the account. If the FIFO–pro-rata hybrid rule is applied, B1 and B2 each receive \$15, and B3 receives the remaining \$50 in the account. This new method of distribution results in a different distribution of funds than under the North American version of the Hybrid Rule, as B1 and B2 would each receive \$20 and B3 would receive \$40. It should also be noted that B1, B2, and B3 would each receive \$26.66 under the pro-rata approach.

The beneficiaries in a mixed trust fund might, for example, opt for the FIFO–pro-rata hybrid rule in situations where the beneficiaries agree that losses should be allocated to earlier investors over later investors because the earlier investors recruited the later investors to invest in the common scheme. It should be possible under the intention-based approach for courts in Australia to allocate losses according to the hybrid version of *Clayton's Case* where the beneficiaries have expressly agreed in the trust documentation to use this specific method of distribution.

VIII Authorised versus Unauthorised Withdrawals

The case of *Re Magarey Farlam Lawyers Trust Accounts [No 3]* ('*Re Magarey*')[161] raises an important question: is there a difference between funds that have been misappropriated by the trustee after making an 'authorised' withdrawal and funds that have been misappropriated after making an 'unauthorised' withdrawal from the trust fund? In *Re Magarey*, 42 beneficiaries authorised the trustee to withdraw their trust funds from the account to make an investment. Instead, the trustee misappropriated the trust funds of

161 (2007) 96 SASR 337.

those 42 beneficiaries after each authorised withdrawal.[162] Debelle J held that since the trustee had only debited the ledgers of the 42 beneficiaries, the losses were limited to those 42, leaving the remaining 250 beneficiaries unaffected:

> The conclusion is consistent with principle. It might be tested this way. If [the trustee] had used the misappropriated money to purchase assets and had retained the ownership of those assets, the 42 clients would be entitled to trace the moneys through to those assets. If those assets were sufficient to indemnify those 42 clients, there is no bar to distributing according to the balance in the ledgers. If those assets do not replace those losses, the 42 clients must accept that loss.[163]

Debelle J rejected that all the beneficiaries had intended to share the losses from the misappropriations as co-owners in a 'common misfortune' because the beneficiaries presumably intended to keep their funds legally segregated.[164] As there were 'reliable records' of all the transactions in and out of the account, the Court did not have to apply any of the fictional tracing methods.[165] This decision is correct, as the 42 beneficiaries had authorised the trustee to make the withdrawals from the account; therefore, the onus was on these beneficiaries to follow up and ensure that their trust funds were being used by the trustee for authorised purposes.

It is argued that the fictional tracing rules only apply in situations where the trustee makes unauthorised withdrawals of trust funds from the account and then misappropriates the funds, or where tracing is impossible. Where the beneficiaries have agreed to hold their trust funds using the LSOC method and the trustee misappropriates trust funds after making an authorised withdrawal, the loss is allocated to the beneficiaries that made the authorised withdrawal. In cases where the trustee made an unauthorised withdrawal, the losses are borne according to whichever method of distribution the beneficiaries have chosen in the contract.[166]

Conversely, where the beneficiaries have agreed to share risk as co-owners in a common pool, it is irrelevant whether the withdrawal of trust funds is authorised or unauthorised before a misappropriation occurs, as the beneficiaries have all agreed to share all the risks on an equal basis. Since a with-

[162] Ibid 380 [146] (Debelle J).

[163] Ibid 382 [152].

[164] Ibid 380 [146].

[165] Ibid 380–1 [147].

[166] The Hybrid Rule applies if the beneficiaries have not specified a method for allocating losses. Alternatively, the pro-rata approach applies if the ledgers are incomplete or inaccurate.

drawal in a common scheme requires the authorisation or permission of all the beneficiaries, they would all be equally responsible for losses resulting from a misappropriation by the trustee.

For example, B1 and B2 each deposit $50 on day 1; T makes an unauthorised withdrawal of $50 and misappropriates the funds on day 2; T makes an authorised withdrawal of $25 as per B1's instructions and then misappropriates the funds on day 3; T declares bankruptcy on day 4, leaving $25 in the account. In a situation where the beneficiaries have agreed to legally segregate their funds, B2 would receive the remaining $25 in the account. Conversely, if the withdrawal of $25 on day 3 had been unauthorised, then B1 and B2 would each receive $12.50 under the Hybrid Rule.[167]

IX Advice for Beneficiaries

A prospective investor should carefully read the language used in any documentation provided by the trustee. Any language about 'co-ownership' or 'equality' will result in a pro-rata distribution, whereas language about 'segregation' will result in distribution according to the Hybrid Rule. If the language in the documentation is unclear, beneficiaries should expect that any losses will be allocated according to the general rule, which is the Hybrid Rule (the North American version), unless the transaction records are inaccurate or incomplete.

A group of beneficiaries should, whenever possible, expressly include in the trust documentation the level of risk that they are willing to take vis-à-vis each other. This decision requires beneficiaries to be aware of how the different distribution methods allocate risk: whereas the FIFO–pro-rata hybrid rule allocates most of the risk to earlier investors, the pro-rata approach allocates the losses equally to all the beneficiaries, regardless of when the funds were deposited in the account and when the misappropriations occurred. The Hybrid Rule imposes an intermediate level of risk by allocating some of the risk to earlier investors. As a result, the FIFO–pro-rata and LIBR–pro-rata hybrid rules incentivise the earlier beneficiaries to act prudently and closely monitor the activities of the trustee.

The beneficiaries could also agree to distribute their losses according to the last in, first out ('LIFO') approach, which is the opposite of FIFO. Although it is not typically a requirement for beneficiaries to monitor the performance of trustees, this approach provides the later investors with an incentive to do so.

[167] B1 and B2 would also each receive $12.50 if they had agreed to hold the funds as co-owners.

However, it is unlikely that beneficiaries would ever opt for this option, as a group of beneficiaries would probably determine that it is unreasonable and unfair to expect the newest beneficiaries to monitor the activities of the trustee, as these beneficiaries would probably not have enough information or statements of the history of transactions in and out of the mixed fund to make an accurate assessment.

X A Framework for Allocating Losses in a Mixed Fund

1 Courts must first consider the express or implied *contractual intention* of the beneficiaries contained in the trust documentation in the case of a shortfall in a mixed fund, as the beneficiaries may have opted for a specific distribution method that satisfies their business needs. The beneficiaries may opt for, inter alia, the following methods of distribution:

   a) the pro-rata approach: this applies where the beneficiaries have agreed to share all risks as co-owners;

   b) the LIBR–pro-rata hybrid rule: this applies where the beneficiaries have agreed to legally segregate and operationally commingle their trust funds. The beneficiaries can opt for either:

      i) the claims version; or

      ii) the rolling charge or North American version;

   c) the rule in *Clayton's Case* (FIFO) or the FIFO–pro-rata hybrid rule; or

   d) any other distribution method (eg LIFO).

2 If the contract or trust documents are silent or unclear as to the method of distribution chosen by the beneficiaries, there is, as the general rule, a legal presumption that the beneficiaries intended to legally segregate their funds and allocate losses according to the North American version of the LIBR–pro-rata hybrid rule. This is the presumption in cases where the parties have opted to commingle their funds in a single omnibus account, as it is possible to legally segregate the funds by using the LSOC model, provided that accurate records of all the transactions are kept.

3 If it is not possible to apply the general rule because the account records are unreliable or incomplete, the court must distribute by using the pro-rata approach.

4 When a trustee deposits its own personal funds into the mixed fund after having misappropriated trust funds, there is a presumption (even where

the trustee expresses otherwise) that the trustee intended to replenish the trust funds. The trustee's personal funds will become trust funds, no matter which method of distribution is applied.

5 Courts of equity should only deviate from these guidelines in order to cater for an innovative situation or where the court needs to consider the unique facts of a case in order to achieve a fair outcome.

XI Concluding Remarks

This article has provided an extensive review of the current legal regime for allocating shortfalls in a mixed fund in Australia. Although this article analysed the rules of distribution from a practical as opposed to a theoretical perspective, the guidelines for allocating shortfalls that I have outlined are compatible with Cutts' theory of intentional transactions.

First, it has been observed that the law in Australia provides judges with flexibility to determine which distribution method to apply on a case-by-case basis where the intention of the beneficiaries is unclear. However, this flexibility poses the risk of creating legally uncertain outcomes for beneficiaries if their presumed intention is ignored.

In order to increase legal certainty in this area, Barkehall Thomas has argued in favour of introducing legislation. She argues that there should be legislation classifying all commingled accounts as 'collective' investment schemes, which will require courts and administrators to adopt the pro-rata approach for all mixed funds.[168] However, a legislative solution is inflexible because it does not consider the intention and business needs of the beneficiaries by allowing them to choose the level of risk that they wish to assume.

Legislation could also hinder the development of tracing rules and innovative business practices in the future.[169] Jessel MR in *Re Hallett's Estate* correctly observed that 'modern [tracing] rules … have been … altered, improved, and refined from time to time'.[170] Equity's flexible remedies such as tracing 'must continue to be moulded to meet the requirements of fairness and justice in specific situations'.[171] It is argued that legislation is unnecessary

[168] Barkehall Thomas, 'Tracing' (n 38) 102.

[169] For example, the introduction of distributed ledger technology into this area may alter the risk appetite of prospective beneficiaries. This new technology can enhance the reliability and accuracy of transaction records by providing immutability, and by storing the transaction history of the commingled account in multiple locations.

[170] *Re Hallett's Estate* (n 68) 710.

[171] *Canson Enterprises Ltd v Boughton & Co* [1991] 3 SCR 534, 588 (La Forest J).

provided that beneficiaries, insolvency administrators, and (where litigation is necessary) courts follow the guidelines for distribution that are outlined in this article.

Second, I have argued that the legal nature of a mixed fund should depend upon the intention of the beneficiaries. The court must first consider this intention when deciding which distribution rule to apply.[172] In situations where the intention of the beneficiaries is unclear, the general rule is that there is a presumed intention on the part of the beneficiaries to keep their funds legally segregated. If there are accurate account records, courts in Australia should distribute the remaining funds by using the North American version of the Hybrid Rule as a fictional tracing rule. This rule pro-ratas the losses among the beneficiaries as each defalcation occurs in the mixed fund. In cases where it is too complex, costly or impossible to distribute according to the Hybrid Rule, due to the lack of accurate records, the court will have to distribute the losses using the basic pro-rata approach.

Third, I have argued that the North American version of the Hybrid Rule is to be preferred as a matter of fairness, justice, and fundamental principles of property law, as a latter contributor cannot logically be forced to share the burden of withdrawals that were made before they ever contributed to the account, unless there was an intention to share as co-owners. This fictional rule comes close to recognising a beneficiary's proprietary rights by allocating the losses more evenly among the beneficiaries than the other methods of distribution. It is unfair to presume that the beneficiaries would assume co-ownership of risks without their knowledge or express consent. The Hybrid Rule also provides the beneficiaries who deposited their funds after the shortfall occurred with the ability to identify and claim the remaining funds in the commingled trust account. As with other tracing rules, this rule permits the beneficiaries whose funds were wrongfully withdrawn and who have suffered a loss to trace the value of their funds out of the account and into a substitute asset.

Fourth, I have argued that trustees in Australia that operate an investment fund should have a fiduciary or statutory obligation to inform the beneficiaries of their options for holding trust funds before they make their first investments. The parties should clearly include this intention in the contract or trust deed to avoid any future legal uncertainty. This should reduce the number of cases that are litigated in court, as insolvency administrators will

172 Chamorro-Courtland, 'Demystifying the LIBR' (n 5) 45.

have a clear guideline for how to allocate losses among the beneficiaries of the mixed fund.

As a final remark, it should be noted that the relevant terms have not always been used precisely in the case law and the legal literature, which poses the risk of creating confusion and legal uncertainty in future decisions. In order to avoid uncertainty, the Hybrid Rule should no longer be referred to as the 'LIBR', as this will cause confusion between the original LIBR and the LIBR–pro-rata hybrid rule.[173] Courts and legal scholars should distinguish between: (1) the original LIBR; (2) the LIBR–pro-rata hybrid rule — either (a) the claims version or (b) the rolling charge or North American version; and (3) the pro-rata approach.

173 I am guilty of referring to the Hybrid Rule as the LIBR in my previous publications.