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Whayman, D. ORCID: https://orcid.org/0000-0003-1026-5646
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LAPOME LTD V KEMP *[2023] EWHC 1564 (CH): MORE QUESTIONS THAN ANSWERS REGARDING TRACING INTO MIXTURES*

Derek Whayman, Newcastle University (derek.whayman@newcastle.ac.uk)

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Equitable tracing continues to confound judges and academics alike, particularly when determining and applying the rules for tracing into mixtures (e.g. *Re Hallett's Estate* (1880) 13 Ch. D. 696 and *Re Oatway* [1903] 2 Ch. 356). Although only a strike-out action, *Lapome Ltd v Kemp* [2023] EWHC 1564 (Ch) makes for a good study into why it is time we got to the bottom of these rules. Given the uncertainty, Master Brightwell wisely refused to strike the action out (he is also a co-author of *Lewin on Trusts*, which takes a strong position on the matter).

The circumstances are where there is a mixture of misappropriated trust property with property from another source. Usually it is in a bank account (the complication that a bank account is a chose in action and not a right of property should be noted but does not affect the outcome). The problem stems from the fact that when withdrawals and deposits are later made, it is conceptually impossible to attribute them to the trust or the other source. Yet rules of some kind have to be fashioned to make an apportionment between the two when the trust property is claimed.

A claimant, generally, can choose any valid claim and is incentivised to make the most valuable one. The issue in *Lapome Ltd v Kemp* concerned the contested right to "cherry-pick" against a trustee at fault and recipients of trust property. I.e. can the beneficiary elect, without restriction, between the options of claiming the money remaining in the account and claiming money that has left the account or its traceable substitute, against *any* recipient who is not a *bona fide* purchaser for value without notice, even if sufficient money remains, without regards to fairness as between the targets? This matter is unsettled. The broad positions are represented by *Shalson v Russo* [2003] EWHC 1637 (Ch); [2005] Ch. 281, where it was said, *obiter*, that cherry-picking should be permitted, and *Turner v Jacob* [2006] EWHC 1317 (Ch), where, by its *ratio*, it was not.

This note sets out the bases and fault lines behind the tracing rules that ought to be examined at trial and beyond, and considers possible solutions to the problems posed. It highlights the place for fault and illustrates its limitations, which arguably shows that ultimately a discretionary bar is needed. It also shows that while a full decision in *Lapome Ltd v Kemp* would give welcome clarity to one aspect of tracing, concerning recipients at fault, there is considerably more for another time, such is the complexity of tracing.

The alleged facts are these. The claimant, Lapome Ltd, asserted that Mr Kemp (the first defendant) and the company he controlled, Kingsbury Investment and Development Consultants Ltd, acted as follows. The seller of the relevant property under a purchasing agent agreement had colluded with Kemp in order to share a secret profit, which plainly would be a breach of fiduciary duty if proven. Lapome further alleged that Kemp caused the second defendant, K Capital Ltd, to make an unauthorised profit of £400,000 less costs, for which both defendants were liable. Kemp argued this amounted to £332,660 (rounded). He offered £500,000 to settle, but the claimant declined.

Kemp's evidence was that £332,600 was paid into a combined system comprised of a "Current Account" and a "Business Reserve Account". Monies were transferred back and forth as needed, but ultimately they operated as "one pot". As a matter of law they are separate accounts, though in such instances the intention to use them as a single account is respected for tracing purposes (*Boscawan v Bajwa* [1996] W.L.R. 328). Note that Master Brightwell did not go so far as declaring this to be the case on the facts (see [16]).

That sum was paid into the current account adding to the previous balance of £51,740. The current account balance then fell to £2,501 because of over 20 relatively small withdrawals (not into the reserve account), most in the thousands of pounds, but including one of £47,500 and one of £20,581. At the time of the claim, the lowest *combined* balance of both accounts was £1,334,576 on the uncontradicted statement of the defendants' counsel. The defendants insisted that since the money in the combined accounts never fell below £332,600, the claimant could not "cherry-pick" into the series of withdrawals, and was thus limited to claiming the principal sum.

The judgment does not say why the complex exercise of tracing into the smaller payments was attractive to the claimant, but (at [13]]) notes there "may" be "assets or investments" to trace in to. If they have gone up in value, absent any defence or bar to cherry-picking, the tracing claimant is entitled to this increase in value notwithstanding the mixing (*Foskett v McKeown* [2001] 1 A.C. 102). Given a surprisingly high offer to settle was made, this is a very distinct possibility.

Master Brightwell began his judgment by noting the relevant mixing rules. When a wrongdoing trustee dissipates money from a mixed fund, this dissipation is attributed to the trustee's own funds first: *Re Hallett*. But if a trustee purchases a substitute from the mixture and then dissipates what remains, the dissipation is attributed to the trustee's own funds and the substitute may be claimed: *Re Oatway*. If one sees them as presumptions of actions, they are irreconcilable, but if considered a principle of subordination of the trustee's interest to the beneficiary's, they function harmoniously (M. J. Hafeez-Baig and J. English, *The Law of Tracing* (Sydney: Federation Press, 2021) paras 6.60–6.66). If so, it follows that the beneficiary may "cherry-pick" the best option of the money in the account or the withdrawals—and indeed their proceeds through any further substitutions. However, no authority has given a definitive answer on how far this can go.

Two other relevant tracing rules were noted. First, tracing is subject to the "lowest intermediate balance" rule, that if an account falls below the value of the beneficiary's interest, the claim in the account is limited to that lowest balance and does not increase on any replenishment (unless that is what the trustee intends). This is on account of the proprietary aspect of the trust. It therefore follows that if this rule is engaged, there is no "cherry-picking" if the claimant chooses another target. Second, in *Re Oatway* (at 361), Joyce J suggested that if the trust fund had been "reinstated" or "restored" to how it should have been, the "charge" allowing tracing would be freed and thus tracing into the substitute refused. Essentially, the defendants wished to engage the second rule.

A recent case, *ED & F Man Capital Markets Ltd v Come Harvest Holdings Ltd* [2022] EWHC 229 (Comm) was also cited, which concerned tracing into the proceeds of the constructive trust that arises on the rescission of a contract. The complication here was that there were a great many recipients who were not *bona fide* purchasers, and thus all were vulnerable to a tracing claim if cherry-picking were allowed unrestricted. The claimant targeted one particular recipient, which Calver J considered arbitrary and he refused this part of the

claim. He held that the *Re Oatway* bar applied and one can only trace when "(i) the money paid out of the mixed fund has been invested by the trustee; (ii) the investment remains under the control of the trustee; and (iii) the rest of the balance has been dissipated" (at [672], [679]).

While the judgment in *Lapome Ltd v Kemp* does have regard to the fault of the trustee (and recipients), one is struck by how little depth of analysis this vital component received. This is perhaps unsurprising on a strike-out action, but nonetheless it is key to understanding and reconciling the different principles across the cases. This absence perhaps also reflects the movement towards seeing tracing as a purely evidential process with little obligational content, where tracing merely identifies the property and the underlying property right determines the extent of the claim. This movement (or "property basis") was driven principally by Peter Birks (e.g. "The Necessity of a Unitary Law of Tracing" in *Making Commercial Law: Essays in Honour of Roy Goode* (Oxford: Clarendon. 1997)), Lionel Smith (*The Law of Tracing* (Oxford: Clarendon 1997)) and Lord Millett (*Foskett v McKeown*).

It is submitted that the movement away from this position (the "fault basis") is key to understanding and solving this problem (see, e.g., T. Cutts, "Tracing, Value and Transactions" (2016) 79 M.L.R. 381; P. Sales, "The Future of Tracing: Practical and Conceptual Issues" [2017] R.L.R. 183 at 191; D. Whayman, "Obligation and Property in Tracing Claims" (2018) 82 Conv. 157; Hafeez-Baig and English, *The Law of Tracing*; P. Ridge, "Tracing and Associated Claims in Australian Law" (2020) 14 J. Eq. 32 and A. Nair, *Claims to Traceable Proceeds: Law, Equity, and the Control of Assets* (Oxford: OUP 2018)). After all, claims based in obligation readily accept fault as an ingredient where property claims do not. Indeed, tracing was originally seen as a response to breach, i.e. it required fault (T. Lewin & F. A. Lewin, *A Practical Treatise on the Law of Trusts*, 6th edn (London: Maxwell & Son, 1875) at 87, 730).

The conventional view, under the property basis, is that the subordinating mixing rules—and any downstream cherry-picking—are justified by the trustee creating an evidential difficulty which is then resolved against the trustee, just as any evidential difficulty is resolved against a wrongdoer: Smith, *The Law of Tracing* at 80. This justification is indeed seen in early cases (e.g. *Lupton v White* (1808) 15 Ves. Jun. 432, 33 E.R. 817), but in *Re Hallett* the justification was the breach of fiduciary duty of making an unauthorised profit, for which the remedy is an account of that profit, i.e. it takes the fault basis (Whayman, "Obligation and Property in Tracing Claims" at 164). This justifies more amply the mixing rules' subordinating nature, and even more so the right to cherry-pick into the most profitable substitution since the imperative is to disgorge unauthorised profits.

It is illuminating to explore the extent to which each basis allows cherry-picking and why. This is done for three broad categories of defendants. First, there are innocent trustees. Second, there are recipients with notice (or perhaps knowledge) of the underlying breach. Third, there are innocent volunteer recipients who have not given value and so are not *bona fide* purchasers but are plainly not wrongdoers.

A solution of sorts is perhaps already in place for innocent trustees, provided 'innocent' and 'wrongdoer' are drawn appropriately. It is submitted that the distinction between the trustees in *Turner v Jacob* and *Re Tilley's Will Trusts* [1967] Ch. 1179, where tracing into the more valuable substitute was not allowed, and those in *Re Hallett* and *Re Oatway*, where it was, is that in the former cases the trustees committed mere breaches of trust without breaching their fiduciary duties. They did not intend to, and did not factually, abstract wealth from their trusts (on the two duties, see Millett LJ's statements in *Bristol and West Building Society v Mothew* [1998] Ch. 1. Also see, e.g., C. Mitchell, P. Mitchell and S. Watterson, *Goff & Jones:*

The Law of Unjust Enrichment, 10th edn (London: Sweet & Maxwell 2022) para 7–53), taking a more sceptical view of *Turner v Jacob* and *Re Tilley*). If one accepts this rationalisation that these trustees were innocent for the purposes of tracing, then there is a bar to cherry-picking in these circumstances since there is no tracing claim at all.

By parity of reasoning, a recipient who has knowingly appropriated or made a profit from trust property ought to be subject to the full rigours of equity (even if accessories are not fiduciaries, similar justifications apply: *Novoship (UK) Ltd v Mikhaylyuk* [2014] EWCA Civ 908; [2015] Q.B. 499). There is no difficulty in fixing liability over such recipients under the fault basis, since they are deemed to receive property impressed with the trust. However, under the property basis, the remarks in *Re Oatway* suggest that since there is no evidential difficulty in identifying the remaining trust property, no traceable property leaves the mixture and thus such recipients would be excused.

The matter of '*Diplock* recipients', after *Re Diplock* [1948] 1 Ch. 465, is perhaps the knottiest. These innocent volunteer recipients who substitute trust property occupy a very different position in fact to those with notice or knowledge of the wrongdoing. Arguably, since they are innocent, they ought to be liable only for the principal sum, secured by a lien over the received property or any substitute they make (and this was the indeed case at the time of *Re Diplock*, before this restriction over mixtures was removed in *Foskett v McKeown*). This would remove the incentive for cherry-picking in many cases, since it is the increase in value which motivates claimants.

A basis in unjust enrichment would solve this problem. However, at the time, English law did not recognise unjust enrichment as an organising principle (despite a separate no-fault claim being confirmed in equity in that case itself), so this route was not open. Even now, authority militates against this route. Attempts to have knowing receipt rebased in unjust enrichment failed, and even though suggesting *innocent* receipt ought to be rebased is a smaller ask, the recent inclination of the Supreme Court has been one of scepticism towards unjust enrichment (e.g. *Barton v Morris* [2023] UKSC 3, [2023] A.C. 684; *Prudential Assurance Co Ltd v Revenue and Customs Commissioners* [2018] UKSC 39; [2019] A.C. 929).

Unfortunately, *Foskett v McKeown* and *Re Diplock* combine to frustrate the other solution. There are strong *dicta* in *Foskett v McKeown* (at 109, 127) insisting tracing concerns the vindication of property rights and not awarding what is 'fair, just and reasonable'. This suggests the discretionary escape-valve in *Re Diplock*, where tracing into land improved with trust property was refused because it would be inequitable, has been swept away. Together, these cases edged out the principle that access to increases in value and the subordinating mixing rules are justified by fiduciary (or similar) breach, and not lesser wrongdoing or even mere receipt. Ultimately this equates the innocent with those at fault, and leaves little from which to fashion a bar against cherry-picking where the innocent recipient is targeted for the trustee's mixing.

In any case, enumerating and analysing these categories allows us to come to two conclusions. First, Calver J's solution in *Man Capital Markets* is too coarse-grained. His assertions lacked theoretical justifications, and while they were a fairer way of determining liability on the facts of that case, they do not address all the possible circumstances, particularly the present ones. Second, while the fault basis allows much more precise targeting of the claim, it still would not fully solve the problem of cherry-picking against innocent recipients where there is a good and practical claim against the wrongdoing trustee.

All this brings us back to *Lapome Ltd v Kemp*. If the claimant succeeds in proving the allegations, the relevant recipients, the two defendants, will be few and will not be innocent. In fact, since the second defendant was under the control of the first, the degree of notice and thus fault would be high. This, it is submitted, will drive the court towards allowing a claim into the most profitable substitutions.

If tracing is permitted, this would give a push away from the property basis. This is because the withdrawals would be deemed trust property irrespective of what remained in the combined accounts. While this outcome could be accommodated under the basis that the trustee had merely created an evidential difficulty, this is a hard argument to sustain when sufficient monies remain in the account (or combined accounts). The easier argument is that what mattered was the acquisitive wrongdoing.

Otherwise, the facts do not present the opportunity for a more substantial rethink of the mixing rules. There will be no need to rule on the correctness of *Re Tilley* and *Turner v Jacob* or the proposed rationalisation, which would give a much more powerful steer in one direction or the other. Likewise the matter of *Diplock* recipients. Neither is there the scope to give a more general answer to the cherry-picking problem which, given the foregoing analysis, probably ultimately requires a discretionary backstop on either basis of tracing (though it would be needed less under the fault basis).

In any case, as Master Brightwell noted, there is enough that considerable thought needs to go into disposing of *Lapome Ltd v Kemp* properly. Moreover, exploration and *obiter dicta* are useful signposts that a more substantial change is coming. They give legal advisers fair warning. They invite further academic and judicial debate. They suggest options which can be re-evaluated against different facts and thus improve rigour. There are many unresolved tensions in the cases, and one has to start somewhere. Even as a mere thought experiment, *Lapome Ltd v Kemp* gives us a great deal to think about.