ALLOCATION OF PAYMENTS BY CREDITORS

When a debtor makes a payment which could be applied to one of several debts, what are the creditor's obligations in respect of allocating that payment?

Must the creditor obey direction by the debtor as to which debt the payment is to be allocated?

In circumstances where there exist a number of debts, it may be the case that some attract interest, or interest at a higher rate than other debts, are secured, or incur a penalty, or might lead to bankruptcy. Clearly, such debts would be more burdensome, and payment of these debts in priority would be beneficial to the debtor.

The Common Law Presumption

When a debtor makes a payment to a creditor, he or she may allocate the money as it pleases them, and the creditor must apply it accordingly. If however the debtor does not make any allocation at the time when the payment is made, that right shifts to the creditor.

Where neither creditor nor debtor makes an appropriation, the presumption is:

1. If a particular debt is more burdensome than others, making it more appropriate - or, beneficial to the debtor – to satisfy that particular debt first, the payment will be applied to the burdensome debt on the basis that this is what the debtor's intention would have been; but
2. If all debts are equal, the payment will be applied to the oldest debts first.

The authority for this rule dates back to 1816 in *Devaynes v Noble* (1816) 35 ER 781.

Best known as 'Clayton's Case', *Devaynes* established the common law presumption in relation to the distribution of monies from a bank account. That is, in the absence of any evidence of contrary intention, payments are presumed to be allocated to debts in the order in which the debts were incurred.

You will find many other references to the rule in English Law (see for example: *Leeson v. Leeson* (1936) 2 K.B. 156; *Cory Brothers & Company v Owners of Turkish Steamship 'Mecca'* [1897] AC 286; *Deeley v Lloyds Bank Limited* [1912] AC 756).

In Australia, the rule was restated by the High Court in *Sibbles v Highfern Pty Ltd* (1987) 164 CLR 214; [1987] HCA 66 and the Federal Court in *Re Walsh; Ex Parte: Deputy Commissioner of Taxation* (1982) 60 FLR 355; [1982] FCA 88.

Judicial Comment

His Honour Lockhart J in *Re Walsh* said:

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'A debtor who owes two debts to a creditor is entitled to appropriate a payment which he makes to his creditor to one debt rather than to the other. If he omits to do so, the creditor may make the appropriation. If neither makes any appropriation, the law appropriates the payment to the earlier debt. If there is specific appropriation by the debtor *cadit quaestio*. In the absence of a specific appropriation it is a question of fact whether there was any appropriation by the debtor. To constitute an appropriation there must be more than an intention to appropriate by the debtor. I respectfully adopt the following passage from the judgment of Greene L.J. in *Leeson v. Leeson* (1936) 2 K.B. 156 at pp. 162-163:-

> *"When, however, he does not notify the creditor of his intention, and when the circumstances are such that the creditor receives the payment merely in satisfaction of the debts and the payment is not more appropriate to the payment of the one debt than to that of the other the creditor is entitled to make the appropriation. When it is said that there need not be an express appropriation of a payment, but that the appropriation can be inferred, that does not mean that appropriation of a payment can be inferred from some undisclosed intention in the mind of the debtor. It is to be inferred from the circumstances of the case as known to both parties. Any other view might lead to injustice, as the creditor's right to appropriate a payment would be defeated. When the matter is examined upon principle it will be found that an undisclosed intention in the mind of the debtor is not sufficient to support an appropriation. If authority is needed for that proposition it can be found in the judgment of Lush J. in* Parker v. Guinness *27 Times L.R. 129, 130 where he said: 'What is to be considered is this. Is the true inference to be drawn from all the circumstances of the case that the debtor paid the moneys generally on account, leaving the creditor to apply them as he thought fit, or is the true inference that he paid them on account of special portions of the debt for the purpose and with a view to wipe these out of the account? His undisclosed intention so to do would, of course, not benefit him. It is what he did in fact, and not what he meant to do that is to be regarded.' A debtor's undisclosed intention to appropriate a payment to one of two debts owed by him to a creditor cannot benefit him."'*

To avoid doubt, an allocation of payment should be communicated to the other party. Greene L.J in *Leeson* pointed out that an undisclosed intention in one's mind cannot be effective allocation of the payment.

Most case law agrees, rather sensibly, that the election must be made at the time of payment – in the case of both debtor and creditor. If neither made an election at that time, the rules of presumption would apply and the payment would be allocated depending on the nature of the debts or the priority in which they were incurred. Naturally it would be the presumed intention of the debtor to make an application of the payment that is most beneficial to them.

Some later English cases have taken the principle much further, to the effect that in the absence of express appropriation by either party, the creditor may, at any time, elect how the payments made shall retrospectively be applied. Thus, the election was not seen to be confined to the period of payment, the creditor being free to make the election when he thinks fit. This has been described as applicable only where the debts do not have distinct existence from each other.

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