PART IV — TRACING

I *Introduction*

A *Definition*

Tracing is a process for identifying value received by the defendant and establishing a causal connection between that value and the plaintiff. It is, in other words, a method of finding property held by the defendant to which a plaintiff is entitled.

Despite often being described as a remedy, tracing is essentially an evidentiary technique, which may in turn give rise to remedies at the suit of the plaintiff. Tracing is simply a precursor to the assertion of their proprietary claim.

Stone and McKeough observe that tracing is normally defined by reference to the colourful metaphor of 'following property into the hands of another'.[1] A more specific description follows:

> *Tracing is the process by which a claimant who has been deprived of property ('the original property') seeks to assert legal or equitable title to other property ('the target property') because the target property has, in some way, been acquired from exploitation of the original property. The process involves establishing an unbroken chain of transfer and transformation from the original property to the target property. If this process is successful, the claimant can claim property rights in the target property and enlist an appropriate remedy* in rem *to recover it.*

Tracing only applies to fungible assets. A fungible asset is a generic right or resource such that any instance of it is as good as any other. For example, money is a fungible asset: in general, any coin or tendered instrument is as valuable as any other equivalent. In *Brady v Stapleton* (1952), Dixon J made the (controversial) observation that sheep are also a type of fungible property. Further examples include grain, gold, copper, uranium and other resources.

Strictly speaking, tracing is only necessary where the plaintiff's property has been transformed in some way (as by exchanging it for other property). If the defendant simply has possession of the plaintiff's original property, it is possible to 'follow' that property directly to the defendant. If the plaintiff has prior legal or equitable title to that property, he or she will be entitled to it in priority to the defendant as a matter of law.

B *Equitable Tracing Rules*

Equitable tracing rules govern the process of tracing. They are broader than their common law equivalents. Collectively, the equitable rules prescribe a method for identifying a chain of title — transactions and transformations — linking plaintiff to defendant, and original property to target property.

Simple cases, as where the plaintiff's money is readily traceable into the defendant's hands as a discrete unit of value in the same form, do not require complex analysis. Instead, the tracing rules deal with three problems:

[1] Margaret Stone and Alistair McKeough, 'Tracing in the Age of Restitution' (2003) 26 *University of New South Wales Law Journal* 377.

1. **Exchange substitutes**
Where the defendant converts the plaintiff's value into another form;

2. **Mixing**
Where the defendant intermingles the plaintiff's money with other funds; and

3. **Accrual in value**
Where the defendant applies the plaintiff's property in such a way as to increase its value.

Tracing itself is little more than 'equity's sniffer dog', and is of little independent interest. However, it does provide the foundation for a secure remedy that affords priority to the plaintiff over the defendant's unsecured creditors. It might also allow the plaintiff to reap the benefit of any increase in value of property held by the defendant. Doctrines of tracing are therefore significant for the fact that they give rise to proprietary (among other) remedies.

C *Relationship with* Barnes v Addy

Property may also be traced into the hands of third parties, providing such parties are not *bona fide* purchasers for value without notice. (This is a defence to a tracing claim: see below Part IV.) Although such a person may not be part of the breach, property can be recovered from them if it is traceable. Alternatively, tracing may provide a proprietary remedy existing alongside personal liability under *Barnes v Addy*, including return of the property.

Tracing is not useful when the property has been dissipated by the person involved in the breach. For example, if the defendant loses the trust property it has received at the casino, tracing will not be available since the tracing chain was broken by the property's dissipation. Naturally, in such a case personal liability would still attach to the defendant by way of a *Barnes v Addy* claim. Conversely, if the property passes to a third party by way of gift, or if the property is exchanged for other property in the possession of the defendant, but the defendant is insolvent, a proprietary remedy is needed. This is where tracing becomes of great importance; it allows such property to be recovered at the suit of a plaintiff.

D *Relationship with Unjust Enrichment*[2]

Restitution is a remedy that allows a plaintiff to recover a benefit received by another in circumstances where it is unjust for that other to retain it. The normative rationale behind unjust enrichment is simple. If A somehow acquires the property of B, but B did not intend to gift it to A, then there is a strong case for demanding its return. Restitution provides just such a mechanism.

However, whereas unjust enrichment is concerned with return of a benefit unjustly received, tracing is concerned with the vindication of property rights. Unlike tracing, for example, restitution does not depend upon the existence of a proprietary right in the plaintiff, nor upon any transactional analysis. Instead, the right is causally linked to the plaintiff: the defendant will only be obliged to make fair and just restitution of a benefit where it is derived *at the expense of* the plaintiff and it is unjust to retain it: *Pavey & Matthews Pty Ltd v Paul* (Deane J).

Tracing and restitution are directed towards the same end; namely, the return of improperly received property from another. However, the content of each is very different. Tracing involves establishing a chain of title; it requires continuity of property rights and has as its basis property

[2] See generally Stone and McKeough, above n 1.

law. Tracing is simply an evidentiary mechanism by which a plaintiff can establish their existing property rights in an asset wrongly held by another. Restitution, by contrast, is founded in unjust enrichment. It is a causal enquiry allowing a claimant to obtain title to property notwithstanding that currently title is held by another.

Despite these differences, some scholars argue that unjust enrichment and tracing should be unified into a single remedial doctrine.

E *Relationship with the Common Law*

Compared with the flexible metaphysics of equitable tracing, tracing at common law is relatively rudimentary and materialistic.

Common law tracing is only possible while property claimed from the defendant continues to derive solely from the plaintiff's original property (*Taylor v Plumer*). That is, once it has been mixed or pooled with other assets, tracing halts. However, a basic transformation of form — such as an exchange from money into goods, goods into money, or one kind of goods into another kind of goods — is no bar to a tracing enquiry.

Taylor v Plumer **(1815) UK:**

Facts
- Plumer asks Walsh to purchase some property for him
- Instead, Walsh buys securities (shares and gold), and attempts to abscond to the United States
- Plumer discovers Walsh's deception, and prevents him from leaving
- Walsh declares bankruptcy
- Walsh is clearly in breach of duty and owes the money to Plumer
- However, Walsh's creditors do not want to return the property since this would reduce the amount they are able to recover from Walsh through his asset pool
- Consequently, his creditors sue Plumer, arguing that he is not entitled to recover the property and should instead be an unsecured creditor to obtain a portion of the pool

Issue
- Is a proprietary tracing remedy available such as to make Plumer a secured creditor?

Reasoning
- Yes, the property can be traced, despite having changed form (money to securities)
- It remains the property of Plumer so long as it is distinguishable from other property
- Tracing only ceases when the 'means of ascertainment' fail
  - For example, if Plumer's money was mixed with $1 of Walsh's own money, and this was then used to purchase shares, common law tracing would fail
  - [By contrast, this sort of mixing would not be fatal to an equitable tracing]

Decision
- Tracing is allowed; however, common law tracing is relatively inflexible

At common law, the rule in *Clayton's Case* governs the tracing of moneys in mixed funds. In short, tracing at law is not permitted into funds derived from more than one source.

Clayton's Case **(1816) NSW SC:**

Issue
- As between banker and customer, when trust funds are mixed into a bank account, how does one identify which money has been taken out of the account and which remains?

Reasoning
- For purposes of convenience, it is presumed that the sum first paid into the account is the sum first drawn on it ('the first in, first out rule')
- This is a rule of convenience, since in reality it would be impossible to distinguish between each deposit and withdrawal (all cash being indistinguishable)
- However, this rule will be overridden by a contrary intention that certain of the moneys were intended to be spent
- In relation to banker and customer, this rule *prima facie* applies (though may be overridden relatively easily); in other contexts, equitable rules apply

Today, tracing at common law is of little significance. Equitable tracing is less onerous, available in a wider spectrum of circumstances, and grants access to equitable proprietary remedies — such as the constructive trust — of far-reaching scope and unparalleled flexibility, as well as declarative and injunctive relief (see, eg, the *Mareva* order).

II *Equitable Tracing Rules*

A *Conceptual Foundation*

Equity adopts a 'metaphysical approach' to tracing.[3] Property can change hands and form across a series of transactions. It can be mixed, separated, grow and diminish in value.

Because of the wide number of circumstances to which tracing is sought to be applied, equity has developed a number of tracing rationales. Most cases oscillate between the two most common of these:

1. **Transaction approach**
   Tracing is an exercise in following value from one person to another in a series of transactions, during which the property may change hands and form; if at any point that value is lost, tracing ends (as in *Lofts*); see, eg, *Smith*; and

2. **Swollen assets theory**
   Tracing is simply a charting of the relative increases and decreases of wealth between the parties; instead of looking for specific transactions, consider the overall effect of the course of conduct (see Simon Evans).

The effect of these theories is considered below.

B *A Fiduciary Precondition?*

Issue: is it a precondition to tracing that there be shown a fiduciary relationship between the plaintiff and someone in the chain?

Equity, it is said, requires a fiduciary obligation to be owed to the claimant by either the defendant or a third party through whose hands the property passed in some form. The status of this requirement in Australia is unclear.

The traditional rule is that the property must relate to or derive from some fiduciary relationship. That is, at least one link in the chain must be fiduciary.

Re Hallett's Estate (1879) UK Ch:

Reasoning
- Equitable tracing rules are applied whenever a fiduciary relationship is established
- It is unclear whether this is meant to exclude tracing in all circumstances in which there is no such relationship, or whether it is just an inclusive statement of form

An alternative view is that all that that must be established is that the claimant has a proprietary interest in the property wrongfully dealt with by the defendant. This view is dominant in the United States of America and New Zealand.

However, the position in Australia is not clear. See, eg, *Black v Freedman & Co*.

[3] *Re Diplock* [1948] Ch 465, 520 (Lord Greene).

Black v Freedman & Co **(1816) NSW SC:**

<u>Facts</u>

- Black, an employee, steals money from his employer
- Some of that money goes to the employee's wife

<u>Issue</u>

- Can money be traced into the wife's hands?

<u>Reasoning</u>

- There is no discussion of whether the employee is in a fiduciary relationship with the employer
- It is unclear whether this means that such a relationship is assumed to exist between employee and employer (it does) and is therefore not mentioned, or whether the failure to refer to a fiduciary relationship simply indicates that such a relationship is unnecessary for tracing
- At this time, the employee–employer relationship was not an established category of presumed fiduciary relationships
- Consequently, it seems more likely that a fiduciary relationship is unnecessary

<u>Decision</u>

- Tracing is available, though whether a fiduciary relationship is a precondition to its availability is unclear

Two reasons are commonly offered in support of such a requirement. First, equity, it is said, acts on the conscience of the recipient, so there must be some fiduciary obligation binding the conscience of the recipient or an intermediary before tracing through that party will be possible. Second, tracing being a mechanism founded in property law, there must be an unbroken chain of proprietary interests.

The legitimacy of the fiduciary requirement must be called into question when regard is had for its deleterious doctrinal effects. In *Chase Manhattan Bank NA v Israel–British Bank (London) Ltd* ('*Chase Manhattan Bank*'), for example, the Court treated the existence of a fiduciary relationship as a requirement for a proprietary tracing remedy. Because of this, it strained to find a fiduciary relationship between two arms-length commercial parties. The Court probably did so because, given the defendant's insolvency, only a proprietary remedy would be effective. However, in so doing, fiduciary doctrines were warped and corrupted for the sake of 'discretionary remedialism'.

As Stone and McKeoh note, the chief difficulty with *Chase Manhattan Bank* is

> *the notion that a person who makes a payment in mistake retains a proprietary interest and the recipient is subject to a fiduciary duty from the moment of recipient. There is no explanation of how the conscience of the recipient can be affected if he or she is unaware of the mistake. …*
>
> *The reasoning (but not the result) in Chase Manhattan Bank seems to us to be flawed. The finding that the recipient of the payment owed fiduciary obligations to the Chase Manhattan Bank seems to be a conclusion subsequent to the conclusion that the mistaken payment should be repaid, rather than antecedent to it. As such the concept of*

> *a fiduciary relationship between the parties added nothing to the analysis of the problem but served only to obscure the reasoning of the court.*[4]

The obvious solution is not to require a fiduciary relationship in order to found a tracing claim. One alternative way to found the claim is to pose that a resulting trust arises upon transfer, so that fiduciary obligations are deferred until the recipient is aware of the mistake: *Port of Brisbane Corporation v ANZ Securities Ltd*.

C *Mixing Rules*

In equity, mixed funds involving trust money are treated differently than at common law. The archetypal case will involve beneficiaries claiming entitlements to proceeds from a breach of trust against the trustee.

1 *Mixing and subsequent withdrawal*

In re Hallett's Estate; Knatchbull v Hallett (1879) UK Ch:

Facts
- A solicitor holds money on trust for clients in the form of Russian bonds
- Several clients' money is misappropriated by Hallett and held in his bank account as a debt owed to him by the bank
- However, Hallett makes several payments out of the account to third parties who take an unencumbered legal interest
- Hallett dies
- The clients discover the fraud and seek to trace their funds into the hands of the estate in order to recover their entitlements

Issue
- Are the clients entitled to trace into the estate?

Reasoning (Jessel MR)
- If the *Clayton* (common law) rule were to be applied, the plaintiffs would not have recovered (since several payments had been made out of the account)
- The plaintiffs argue that a different equitable rule should apply because the defendant is a defaulting fiduciary who has stolen in equity
  - Note that, although there is clear equitable fraud on these facts, if the fiduciary's behaviour can be conceivably described as lawful and not in breach of duty, then the Court will construe their behaviour in the most favourable light for tracing purposes
- This submission is accepted; a separate, equitable tracing principle should apply in circumstances where:
  - A fiduciary misappropriates trust money; then
  - Mixes that money with his or her own money; and
  - Dissipates that money in some way
- Principle: the fiduciary will be treated as dissipating his or her own money first
  - Any withdrawals are treated as first drawing on their own money, not the beneficiary's, to the extent possible

[4] Stone and McKeough, above n 1, 385.

- This is most consistent with the principle that the breaching fiduciary's conduct will be construed as favourably as possible
- Since the fiduciary is entitled to withdraw their own moneys from their account, but not entitled to withdraw trust moneys belonging in equity to their principal, their withdrawals will be construed accordingly — as diminishing their own, lawfully held funds, not those of the trust
- Trust money will only be dissipated to the extent that withdrawals exceed the value of the trustee's own funds
- (However, if the trust money is dissipated, subsequent deposits will not be traceable by the beneficiary: *Lofts v MacDonald*) ('the lowest intermediate account balance rule')

Decision

- The clients can recover from the estate, since the withdrawals did not affect trust money

These cases demonstrate that tracing is only available to effect recovery of assets in which the plaintiff itself has a proprietary interest. This reveals the property law foundations of tracing in equity.

Another example of tracing was provided in *Re Diplock*, where the Court of Appeal held (and the House of Lords affirmed) that tracing was available against wrongful recipients under an invalid residuary clause in a will. The executors could trace into payments made to these recipients to the extent that they could be identified and disentangled from other property.

2 *Mixing and subsequent investment*

If the trust funds are withdrawn and subsequently invested, a plaintiff may make a claim with respect to the investment (which may have accrued in value) in proportion to their share in the money invested. This issue was first considered in *Re Oatway*.

In general, the beneficiary is entitled to profits in proportion to their own 'contribution' by way of money misapplied by the breaching fiduciary.

Re Oatway **(1903) UK Ch:**

Facts

- Oatway is a solicitor; he deposits £7000 into a bank account (£3000 of which is misappropriated trust money, £4000 of his own money)
- Oatway withdraws £2137 and uses it to purchase shares in a company called OCR
- The balance of the account, following this withdrawal, is £4863, but Oatway subsequently becomes insolvent and dies
- The plaintiff, the beneficiary of Oatway's client trust fund, seeks recovery of the money
- The shares are the only asset available against which to make a claim

Issue

- Can the plaintiff trace their trust money into the shares?

Reasoning (Joyce J)

- If *Re Hallett's Estate* was applied, the fiduciary's own money would be presumed to be withdrawn, so that the entire investment could be traceable only to Oatway's funds, not

the plaintiff's
- The plaintiff would not be able to recover, since the remaining funds were dissipated
- 'The fiduciary must be debited with all sums [drawn and dissipated]'
- 'The trust must be debited with any sums taken out and duly invested'
- Thus, the fiduciary will be deemed to have withdrawn his own money, and the trust money will be taken to have been drawn and invested in the shares

Decision
- The trust money is therefore traceable to the shares, and the plaintiff can recover to that extent
- The plaintiff can recover £2137 of their £3000 misappropriation

Thus, where trust money has been invested, the plaintiff can trace into the investment since the trust money will be deemed to have been invested. Essentially, the fiduciary will be treated as dissipating their own funds first (unless all funds are dissipated).

Although this is a reasonably clear rule capable of certain application, the *ad hoc* development of these concessionary rules in response to situations of unjust retention does invoke a vision of tracing as a kind of restitution.

Lofts v MacDonald reflects the fact that equitable tracing rules do have limits for plaintiffs. Although *Re Hallett* means that the defendant is treated as dissipating his own money first, once those funds are exhausted the trust money begins to be spent. Trust money cannot be traced to the extent it is spent.

Lofts v MacDonald **(1974) Qld SC:**

Facts
- A builder, MacDonald, contracts with the Lofts to build their house
- In return, the Lofts pay $1600 to MacDonald, to be held on trust and used to meet building expenses
- However, MacDonald deposits the $1600 into his own bank account (in breach of trust)
- Several days later, MacDonald dies
- His estate continues to operate the bank account, collecting on and paying out debts
- The balance of the account fluctuates, but reaches a lowest point of $8.42
- At the time when the estate was declared insolvent (not being able to meet its debts), the account's balance is approximately $2800
- At this point, the balance is frozen and insolvency proceedings are commenced
- The Lofts now seek first recovery of their $1600 by tracing it to the account; they want to have priority over MacDonald's other creditors by tracing

Issue
- Is tracing for the $1600 possible despite the fact that the balance dropped well below $1600 — was the trust money dissipated at that point?

Reasoning
- *Re Hallett's Estate* is the starting point; it suggests that MacDonald's executors spent MacDonald's own money first, up to the last remaining $1600
- However, this principle only applies when there is always an amount in the account capable of meeting the debt *in addition to* the trust money

- If at any time the balance drops below the amount of misappropriated trust money, tracing will no longer be possible to the extent that the debt cannot be satisfied (those funds are deemed to be dissipated)
- Here, the balance dropped below $1600, to $8.42, at one point

Decision
- The Lofts are awarded a charge over the account to the extent of $8.42, but no more

Lofts as decided reflects a decidedly transactional approach to tracing: the balance of the account is tracked through its various states in linear, chronological fashion, such that a dip in the balance at an early stage prevents full recovery later. According to the swollen assets theory, however, *Lofts* should have been decided differently. At all times, MacDonald's estate was unjustly enriched by the inclusion of the $1600, using which it was able to stave of bankruptcy and pay its debts for some finite period. If the true rationale for tracing is restitutionary in nature, it ought not to matter how any intermediate transactions affected the defendant's value — just that the defendant has been enriched by the breach, and is now presently capable of making restitution.

D *Tracing Where Property Increases in Value*

1 *Proportionate contributions*

Scott v Scott is a dispute between the family of a defaulting fiduciary and the deceased's second wife. The property the subject of the trust is a house. It sets out the following tracing rules:

(a) If an asset has been acquired solely with the plaintiff's money, a constructive trust will be granted over the asset in favour of the plaintiff;

(b) Otherwise, a plaintiff can trace into the full value of an acquired asset in proportion to the amount of their money used to acquire it;

(c) Deductions must be made for any money already repaid to the plaintiff;

(d) The plaintiff will be entitled to a proportionate share in the remaining value of the property;

(e) The remedy depends on the nature of the asset that has been acquired:

  (i) If the property is specifically severable, it will be divided in proportion to the parties' beneficial entitlements;

  (ii) Otherwise, the plaintiff can choose between an account of profits and a constructive trust;

  (iii) If the plaintiff elects to receive an account of profits over a fixed (not floating) asset, it can be secured by an equitable charge or lien over the portion of the asset to which the plaintiff is entitled;

  (iv) If the plaintiff elects to receive a constructive trust, one will be imposed to the extent of the plaintiff's entitlement, but the plaintiff must be the risk of any fluctuations in value from the date of judgment;

(f) All valuations are to take place from the date of judgment.

Scott v Scott **(1964) HCA:**

<u>Facts</u>

- Mr Scott is trustee of the Scott family trust, which owns a house in Preston
- The beneficiaries of this trust are Scott family members
- In 1942, Scott, in breach of trust, sells the Preston house and purchases a new one in Malvern in his own name from the trust
- The purchase was financed partly by his own funds, partly by loan from a beneficiary, and party with trust money
    - In 1942, the purchase price is £1700
    - £1014 of this is trust money (60 per cent) ('the misappropriated amount'), being the amount obtained from the sale of the Preston house
- Scott pays all this money back to the trust (though with no interest)
- In the early 1960s, Scott dies, leaving the house to his second wife, who is not a beneficiary of the Scott family trust
- In 1963, the house is valued at £5450 pounds
- The other members of Scott's family do not want Scott's second wife to obtain the house
- Consequently, the beneficiaries sue Mrs Scott, claiming an equitable interest in the house (for breach of trust)
    - The plaintiff beneficiaries do not seek restitution (they already have been paid the loan amount)
    - They want to obtain some of the increased value and, if possible, a proprietary remedy over the house itself

<u>Issue</u>

- Can the plaintiffs' trust money be traced into the Malvern house?

<u>Reasoning</u>

- Tracing serves two related purposes:
    - Restoring misappropriated trust money (Scott has done this)
    - Accounting for profits generated through a breach of trust (underlies all of fiduciary law)

- Here, the increase in value represents profits made by the defaulting trustee; it cannot be permitted to retain that value
    - The beneficiary, Mrs Scott, is a volunteer and has no better title than the donor (Mr Scott)

- If the asset has been acquired using only trust money (no other money), the beneficiaries can trace into it and take it back in its entirety
    - This will be effected by declaring a constructive trust over the asset in favour of the beneficiary
    - The Court will then order that the trust be carried out (discharged) and the asset transferred

- If trust money has been combined with other money and used to purchase an asset, the beneficiary will not be entitled to trace into the entirety of the asset
    - There are two rules for two types of cases
    - If the asset is 'specifically severable' (when an asset can be split into the part deriving from the beneficiary's wrongfully misappropriated property: eg, shares [numbered share certificates]), it will be divided in proportion to the beneficiaries' entitlement

- If, however, the asset is not severable (eg, a house is not 'specifically severable'), a different rule applies
  - The beneficiary is entitled to a charge (or a lien) over the asset to the extent necessary to secure repayment of the profits
  - The charge or lien will exist over the proportion of the asset's total value as was comprised by the proportion of the beneficiary's money used to acquire it

- Here, the asset is not specifically severable, so the beneficiaries are only entitled to a charge over the house to the extent that the profit is attributable to the misappropriated trust money
  - 60 per cent of the purchase price was misappropriated trust money
  - The value is now £5450
  - Scott had repaid the misappropriated funds
  - Therefore, only the proportional increase in value is recoverable
  - So: the increase in value is
    - £5450 (current price) - £1700 (capital repaid) = £3750 (total profit)
  - Of this, the beneficiaries are entitled to 60 per cent (£2250)

<u>Decision</u>

- The plaintiffs can trace the trust money into the house
- They are entitled to 60 per cent of the house's current value, that being the proportion of their initial contribution to the purchase price, less what has already been repaid
- An account of profits is ordered in the amount of the increased value of the Malvern house, as at the date of judgment
- The account of profits is secured by an equitable lien; this ensures that, in the event that the beneficiaries are not repaid their share, the house can be sold off to apply that amount
- An alternative remedy described as available by the Court is that of constructive trust
  - A constructive trust could be imposed over the house in the amount of 60 per cent
  - The beneficiaries would have had a 60 per cent equitable interest in the Malvern home
  - This would permit further increases in value to be apportioned in accordance with the beneficiaries' entitlement, and is a more flexible remedy
  - This would also allow the plaintiffs to postpone sale and obtain more money
  - (Naturally, though, this runs the risk of the house decreasing in value)

- The Court orders the sale of the house; the proceeds are gathered and distributed in the proportion of the parties' beneficial entitlements (60 per cent, 40 percent to the Scott family beneficiaries and the second wife, respectively)
- It is unclear whether the final value of the investment should be assessed as at the time of Scott's death, or at the time of judgment: the approach that appears to have been adopted is that values are fixed when the trial judge delivers judgment

Several criticisms may be made of the outcome in *Scott*.

First, it arguably encourages fiduciaries to breach their duties. A breaching fiduciary will remain entitled to whatever proportion of their wrongful investment as they themselves made. Only the proportion of the investment made with the investor's money must be disgorged. This means that, even though the fiduciary may not have been able to make the investment at all were it not for the (unwilling) assistance of the beneficiaries, it will nevertheless be entitled to reap a share of the profits from that investment.

Second, although the plaintiffs in *Scott* only claimed an entitlement to a proportion of the profit — and not its entirety — the outcome has nevertheless been criticised as too generous to the fiduciary. Such critics argue that the breaching fiduciary should only be entitled to recover their initial contribution — not its accrued value. Such an approach would, it is argued, be more consistent with *Warman v Dwyer* and *Boardman v Phipps*, in that the fiduciary would not be entitled to *any* gain from their position, rather than the 'proportional gain' permitted in *Scott*. There may be some scope for arguing this in an Australian court, given the basis on which *Scott* was argued before the Court.

Where solely the beneficiary's money has been used to purchase an asset, the beneficiary may elect to take the asset completely.

If the asset was partially acquired with the trustee's own money and is specifically severable, the wronged beneficiary may elect to take the proportion of the asset to which they are entitled, including any increase in value, providing that entitlement is offset against any repayments made by the trustee to the beneficiary.

If the asset is not specifically severable, a charge, lien or constructive trust will be awarded over the asset in proportion to the beneficiary's deemed contribution.

2 *Tracing into windfalls*

Suppose a solicitor wrongfully withdraws $2.80 from a client trust account. He has committed a breach of trust and is liable to reimburse the trust that amount. Clearly, a beneficiary could follow the money into the solicitor's hands. However, suppose also that he purchases a lottery ticket with the money, and wins. To how much, if any, of the $2.8m winnings is the beneficiary entitled?

According to *Foskett v McKeown* ('*Foskett*'), the beneficiary would be entitled to trace into all of it. In *Foskett*, however, the windfall was not a lottery payout but a matured life insurance policy; the beneficiaries were not clients but investors; and the beneficiary did not contribute 100 per cent of the purchase price, but rather, 40 per cent. In these circumstances, the House of Lords held that the beneficiary investors could trace into 40 per cent of the policy.

The rule is as follows (at 131):

> *Where a trustee wrongfully uses trust money to provide part of the cost of acquiring an asset, the beneficiary is entitled* at his option *either to claim a proportionate share of the asset or to enforce a lien upon it to secure his personal claim against the trustee for the amount of the misapplied money. It does not matter whether the trustee mixed the trust money with his own in a single fund before using it to acquire the asset, or made separate payments (whether simultaneously or sequentially) out of the differently owned funds to acquire a single asset.* (emphasis in original)

***Foskett v McKeown* (2001) HL:**

<u>Facts</u>

- Timothy Murphy is a British property developer
- He devises a property development scheme in Portugal
- In 1988, several British investors interested in the development enter into an agreement with Murphy, paying him (and some other trustees) a total of £2.6m
- The development never proceeds, and Murphy and the other trustees misappropriate all

of the money for their own nefarious schemes
- The investors discover this and want to reclaim their investment; however, no trustee has the assets to satisfy the debt
- However, there is another possibility
- Murphy had used £20 000 of the trust money to pay off two premiums on his life insurance policy
- The policy was first taken out in 1986, and cost £10 220 in premiums per year
- Murphy paid a total of five annual premiums on this policy, the first two with his own money ('the 1986 and 1987 payments')
- The third ('the 1988 payment') is unclear: it may have been paid by Murphy or by the trust money
- In 1989, however, it is incontrovertible that the trust money was used, as it was in 1990
- Thus, a total of £50 000 in policy payments made, of which £20 000 were misapplications of trust money
- The terms of this policy provide £1 000 000 to the estate in the event of death
- In 1991, Murphy commits suicide; his wife and children receive the payment
- The investors argue that they are entitled to 2/5$^{\text{ths}}$ of the payout, because 2/5$^{\text{ths}}$ of the premium payments can be traced through Murphy's hands to the misappropriated trust money
  - They seek to trace their £20 000 into the £1 000 000 payout
  - That is, they claim a proprietary interest in £400 000 of the money in the account belonging to Murphy's widow and children
- Murphy's widow and children were volunteers and will lose priority to a prior equitable interest
- Court of Appeal: the investors can trace their investment money through the premium payments into Murphy's insurance policy; an equitable lien is granted over £20 000 of the money, that being the amount of the policy paid using the investors' funds
- The investors appeal to the House of Lords, arguing that they should be entitled to a share of the total proceeds from the policy in proportion to their contribution (ie £400 000)

<u>Issue</u>
- Can the investors trace into the payout from the life insurance policy in proportion to the premium payments made by Murphy using their misappropriate trust moneys?

<u>Reasoning</u>
- Lord Browne-Wilkinson:
  - 'The question which arises in this case is whether, for tracing purposes, the payments of the fourth and fifth premiums on a policy which, up to that date, had been the sole property of the children for tracing purposes fall to be treated as analogous to the expenditure of cash on the physical property of another or as analogous to the mixture of moneys in a bank account.'
  - This question should be resolved in favour of the latter option: the contributions to the premium were more akin to payments into a mixed fund
  - Consequently, the whole of the mixed fund is held subject to an equitable charge in proportion to the investors' contributions (40 per cent)

- Lord Millett:
  - 'My Lords, this is a textbook example of tracing through mixed substitutions'
    - First, the property was held on express trust for the plaintiffs in Murphy's bank account
    - Second, the money became 'inextricably mixed' through with Murphy's own money through various transactions and transferrals
    - Third, the trust money became 'an indistinguishable part of a chose in action, viz, the debt prospectively and contingently due from an

insurance company to its policyholders'
  - Fourth, the trust money forms 'an indistinguishable part of the balance standing to the credit of the respondent trustees in their bank account.'

- A distinction must be drawn between tracing and following
  - '**[127]** Following is the process of following the same asset as it moves from hand to hand' (in an unchanged form)
  - '**[127]** Tracing is the process of identifying a new asset as the substitute for the old' (by some transactional transformation, or change in value)
  - The plaintiffs seek to trace the money at each stage into the proceeds, being a debt due from the bank to the account holder and a debt due from the insurance company to the policy holders

- Tracing is a matter of property law, but is neither doctrine nor remedy: it is merely a technique for finding value
  - 'The claimant succeeds if at all by virtue of his own title, not to reverse unjust enrichment. Property rights are determined by fixed rules and settled principles. They are not discretionary. They do not depend upon ideas of what is "fair, just and reasonable". Such concepts, which in reality mask decisions of legal policy, have no place in the law of property.'
  - Tracing involves finding value, not assets: at 128
  - '**[128]** Tracing is thus 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.'
  - '**[128]** Tracing is also distinct from claiming. It identifies the traceable proceeds of the claimant's property. It enables the claimant to substitute the traceable proceeds for the original asset as the subject matter of his claim. But it does not affect or establish his claim.'
  - The property law claim subsequent to tracing may be subject to defences as a result of, for example, a good faith purchase in the intervening transactions sufficient to extinguish title
  - 'The successful completion of a tracing exercise may be preliminary to a personal claim (as in *El Ajou v Dollar Land Holdings plc* …) or a proprietary one, to the enforcement of a legal right (as in *Trustees of the Property of F C Jones & Sons v Jones* …) or an equitable one.'

- Because of its nature, tracing rules at common law and in equity should be fused
  - 'Given its nature, there is nothing inherently legal or equitable about the tracing exercise. There is thus no sense in maintaining different rules for tracing at law and in equity. One set of tracing rules is enough.'
  - The two approaches should be merged into a set of 'unitary tracing rules'
  - If tracing is simply a process of identifying the plaintiff's money in the defendant's hands, why should it differ depending on whether it proceeds at law or in equity?
  - [Cf Meagher, Gummow and Lehane: fusion fallacy]

- Tracing is not a cause of action
  - '**[129]** … a plaintiff who brings an action like the present must show that the defendant is in receipt of property which belongs beneficially to him or its traceable proceeds, but he need not show that the defendant has been enriched by its receipt. He may, for example, have paid full value for the property, but he is still required to disgorge it if he received it with

notice of the plaintiff's interest.'
  - '**[129]** Furthermore, a claim in unjust enrichment is subject to a change of position defence, which usually operates by reducing or extinguishing the element of enrichment. An action like the present is subject to the *bona fide* purchaser for value defence, which operates to clear the defendant's title.'
  - This suggests that change of position is not available as a defence to a claim based in property law, but good faith purchase is

- Basic principles of tracing
  - Acquisition of an asset wholly with misappropriated trust money:
    - Beneficiary entitled '*at his option*' to assert beneficial ownership of the asset or claim in breach of trust and enforce an equitable lien or charge over it to secure restoration
    - If the proceeds have increased in value, beneficial ownership should be asserted to obtain that profit
    - The trustee cannot keep any profit resulting from this misappropriation for himself
    - Further, his donees cannot obtain better title than their donor
    - If, however, the proceeds are worth less than the misappropriated money, 'it does not usually matter how the beneficiary exercises his option [since] [h]e will take the whole of the proceeds on either basis' (though presumably a breach of trust action would entitle the claimant to equitable compensation for the full value of the loss)
    - Both claims are proprietary: tracing into the proceeds is an essential precondition to their success
    - Failure to trace limits the claimant to a personal claim against the trustee
    - However, a proprietary claim can be maintained against the breaching fiduciary and anyone who derives title from him, except a *bona fide* purchaser for value without notice of the breach of trust
  - Acquisition of an assert with mixed funds:
    - Beneficiary has the option of taking a proportionate part of the new property or a lien upon it, 'as may be most for his advantage'
    - 'In every case the value formerly inherent in the trust property has become located within the value inherent in the new asset.'
    - Sir George Jessel MR appears to have implied in *In re Hallett's Estate; Knatchbull v Hallett* that the remedy is limited to a lien
    - This is not the case: at 131
    - '**[131]** Where a trustee wrongfully uses trust money to provide part of the cost of acquiring an asset, the beneficiary is entitled *at his option* either to claim a proportionate share of the asset or to enforce a lien upon it to secure his personal claim against the trustee for the amount of the misapplied money. It does not matter whether the trustee mixed the trust money with his own in a single fund before using it to acquire the asset, or made separate payments (whether simultaneously or sequentially) out of the differently owned funds to acquire a single asset.' (emphasis in original)

- No fiduciary relationship is necessary in order to trace, and any such

requirement, if it exists, should be abolished
- This follows from a fusion of law and equity (tracing should not depend on the existence of a particular class of equitable relationship)
- Tracing is part of the law of property, not the law of unjust enrichment
- [Cf Lionel Smith: tracing belongs to the law of unjust enrichment; here, the children should be viewed as having been unjustly enriched by an insurance policy purchased with the beneficiaries' money]
- The present appeal is a property law claim: the investors seek return of their £20 000, including any accrued value

- These distinctions are most relevant to defences:
  - If tracing is a claim in unjust enrichment, a possible defence is good faith change of position
    - Thus if, for example, the children decided to spend their windfall in some way, they would be protected under this defence
  - However, by treating the claim as one of property, no defence is available
    - The children are not purchasers, so the *bona fide* purchaser for value without notice defence does not apply
  - [Were the High Court to consider the issue, it would most likely follow Lord Millett in this regard: there is 'considerable hostility' towards unjust enrichment]

- In the result, then, this is 'a straightforward case' of misappropriated trust money, later mixed with Murphy's own money and used to purchase an asset for the benefit of his wife and children
  - The fact that Murphy died, and the other of events, does not alter the fact that his widow and children are volunteers in equity
  - They did not pay consideration for the policy, instead taking its benefits as a gift, paid for in part with misappropriated trust money
  - When the policy matures (becomes payable), the resulting payout represents proceeds traceable to the misappropriated funds

- When did Murphy acquire his rights under the insurance policy?
  - '**[134]** It is … of critical importance in the present case to appreciate that the plaintiffs do not trace the premiums directly into the insurance money. They trace them first into the policy and thence into the proceeds of the policy. It is essential not to elide the two steps.'
  - There are two stages to the acquisition of rights
  - First, tracing from Murphy's premium payments to the acquired rights under the contract (a chose in action)
  - Second, tracing from the acquired rights to the final policy payment in exchange for giving up those rights
  - '**[134]** It follows that, if a claimant can show that premiums were paid with his money, he can claim a proportionate share of the policy.'
  - This is because the nature of the interest does not affect the application of tracing principles: the same tracing rules apply whether the asset is a life insurance policy, bank account or lottery ticket

- The defendants argue that if the rights came on foot in 1986, the trust moneys were not used to appropriate the rights
  - Majority: no, as a matter of insurance contract law, the trust moneys ere used to acquire the rights
  - Minority: yes, the rights were acquired by the earlier (non-trust) payments, so no tracing is possible

- The beneficiaries have a beneficial interest in the trust money; this interest binds not only Murphy but also his successors in title, including volunteers who either receive trust property or its traceable proceeds

- The relief granted to uphold this equitable title will depend on the nature of the interest and the kind of proceeds

- Where the beneficiary can trace and claim the asset, they have two options:
  - First, they can claim a proportionate share of the asset (declaring a constructive trust)
  - Second, they can seek repayment of the trust money (or an account of profits — see *Scott v Scott*) secured by a charge or lien
  - The plaintiff must elect between these options

Decision

- (3:2) The investors will receive £400 000 (being 2/5ths of the total amount gained through the misappropriation)
- Majority: Lords Browne-Wilkinson, Hoffmann and Millett
  - In form, the remedy is an account of profits
  - However, in substance, a constructive trust is awarded: a 'proportionate share'
  - [Cf *Scott*: here a constructive trust is actually awarded]
  - [In general, a constructive trust should be sought where the investment has the potential to further increase in value after the date of judgment]
- Minority: Lords Steyn and Hope of Craighead
  - The investors are just entitled to restitution of the misapplied money (being £20 440) by way of equitable lien

Scott highlights the two competing approaches to tracing: punishment of a wrong (breach of fiduciary duty and prevention of profit) or simply the return of property and enforcement of property rights.

The majority in *Foskett* favours a property rights view: tracing is simply a mechanism for determining existing property rights (and in any case, fiduciaries should not benefit from their breaches). The majority considers fairness and justice (whether the effect is proportionate to the defendants' wrong, etc).

Foskett represents the more modern view of tracing. The High Court would, faced with a similar case, probably follow *Foskett* over *Scott*. A constructive trust would probably be available.

Perhaps the best explanation of the rationale in *Foskett* is provided by the following extract from the judgment of Lord Millett:

> *Where A misappropriates B's money and uses it to buy a winning ticket in the lottery, B is entitled to the winnings. Since A is a wrongdoer, it is irrelevant that he could have used his own money if in fact he used B's. This may seem to give B an undeserved windfall, but the result is not unjust. Had B discovered the fraud before the draw, he could have decided whether to keep the ticket or demand his money back. He alone has the right to decide whether to gamble with his own money. If A keeps him in ignorance until after the draw, he suffers the consequence. He cannot deprive B of his right to choose what to do with his own money; but he can give him an informed choice.*

Although persuasive, there are some problems with this analysis. Presumably, for example, it suggests that, if B does learn of the misappropriation prior to the draw but chooses to stay silent, and the ticket subsequently turns out to be a losing ticket, B will no longer be able to claim entitlement to compensation for the misappropriated funds, since B has effectively chosen to 'gamble with his own money'. However, this is to do one of two things that, if not wrong, at least warrant explanation: (i) to import a mental element into the definition of a tracing right; or (ii) to bar a claimant by election from proceeding with a common law claim founded in tracing. It is unclear whether these are necessary or merely unintended consequences of Lord Millett's analysis.

However, Lord Millett does anticipate these objections, to an extent:

> *Had [the plaintiffs] discovered what had happened before Mr Murphy died, they would have intervened. They might or might not have elected to take an interest in the policy rather than enforce a lien for the return of premiums paid with their money …. At the date of his death Mr Murphy was only 45 and a non-smoker. He had a life expectancy of many years …. The plaintiffs would hardly have been prepared to wait for years to recover their money, paying the premiums in the meantime. … They would obviously have chosen to enforce their lien to recover the premiums or have sought a declaration that the trustees held the policy for Mr Murphy's children and themselves as tenants in common in the appropriate shares. … In practice the trustees were able to obtain the death benefit by maintaining the policy until Mr Murphy's death only because the plaintiffs were kept in ignorance of the fact that premiums had been paid with their money and so were unable to intervene.*

3 *Subsequent criticism*

In his scholarly case note, published shortly after the decision in *Foskett v McKeown*, Alan Berg made several criticisms of the majority reasoning.

The consequence of the decision, argues Berg, is that a beneficiary can only claim a proportionate share of profit and not its entirety. Although the position in the United States and Australia (see *Scott v Scott*), this reasoning is faulty because it permits the breaching fiduciary himself to retain a proportionate share of the profits. It may be contrasted with the situation where an acquisition occurs on the basis of information obtained by a fiduciary in the course of his duties: such a fiduciary, in breach, would need to account for the entirety of the profits, not just some fraction corresponding to the amount of the principal's money.

Cases like *Foskett* and *Scott* therefore permit the fiduciary (or, in *Foskett*, the heirs) to retain too much of the money. The beneficiaries (in *Foskett*, the investors) should be entitled to the whole profit except the amount of the fiduciary's own contribution. This would be more consistent with the 'no profit' rule in *Keech v Sanford* and *Boardman v Phipps*. Equity should treat a breaching fiduciary according to the 'good man' theory of equity, pretending that the profit was not obtained for himself as principal but instead as a conscientious trustee acting for the beneficiary.

However, this stricter position was not argued in *Foskett*. Certainly, it would seem unfair to the heirs in light of the circumstances — visiting upon them the sins of their father. Instead, the focus was on the 'wholly unwarranted windfall' that was said to be received by the *investors* if they were granted a share of the policy payout.

Nevertheless, even had the investors argued for the stricter position, the heirs could have argued that the policy would still have been received even without the last two premiums (since the policy had by that stage a standing period of two years in which a payout would be received despite non-payment). Arguments about intention, trustees not profiting from their trusts, and financial regulatory policy may be raised in reply.

Further, it is argued, the children in *Foskett*, and the trustee in *Scott*, are volunteers, so there should be no justification for allowing them to retain their ill-gotten gains.

Berg also noes that '[t]heir Lordships stood counsel's arguments on their heads.'[5] Apparently, the plaintiffs succeeded precisely because the Court rejected their argument about equitable principles in favour of the defendant's view that the case was about property rights.

According to Berg, the House of Lords should have adopted a stricter approach that would remove any possible incentive for a trustee to misappropriate funds and mix them with his or her own. In the wake of financial mismanagement and large-scale corporate collapses, in a period of ever-deteriorating business ethics and ever-increasing temptations, imposing high standards of conduct upon fiduciaries has never been more important.

The correct outcome in *Foskett* was to order repayment of £30 660 to Murphy's widow and children, and declare a constructive trust in favour of the investors over the remaining £969 340.

The difference between Berg and supporters of *Foskett* may largely be explained by sympathy for the fiduciary's children. Supporters should bear in mind that the children *did* receive £600 000. The issue is: to how much of the profit should the children be entitled? Some portion of it, or none? Professor Bryan supports Berg's view (none, subject to return of the premium payments).

E *Dividing Value among Multiple Beneficiaries*

The archetypal situation involving multiple beneficiaries arises where a solicitor, acting dishonestly, misapplies money in a trust account belonging to multiple clients. The money belongs in equity to the clients, and they will be entitled to trace into its proceeds. However, consider the situation in which some of the money has been lost or dissipated. The issue here is how the remaining money should be divided among the beneficiaries.

In *Re Stenning* (1898) the Court of Chancery applied the rule in *Clayton's Case*. Stenning, a dishonest solicitor, appropriated money belonging to Mrs Smith and four other clients. Because Mrs Smith's money was the first money paid into the account, hers was deemed the first paid out.

Austin Scott has described the rule in *Clayton's Case* as like 'an unruly dog that has been allowed to wander outside the common law and wreak injustice in equity'. The main criticism is that it is arbitrary. There is no reason why Mrs Smith should lose her money as against the other clients.

In *Foskett v McKeown*, Lord Millett returned to the maxim *aequitas est aequalitas*. His Lordship decided that multiple beneficiaries would share rateably in the traceable proceeds, that is, in proportion to the amount of their contributions:

> *Where the beneficiary's claim is in competition with the claims of other innocent contributors, there is no basis upon which any of the claims can be subordinated to any of the others. Where the fund is deficient, the beneficiary is not entitled to enforce a lien for his contributions; all must share rateably in the fund.*
>
> *The primary rule in regard to a mixed fund, therefore, is that gains and losses are borne by the contributors rateably.*[6]

More recently, see *Keefe v Law Society of New South Wales*.

---

[5] Alan Berg, 'Permitting a Trustee to Retain a Profit' (2001) 117 *Law Quarterly Review* 366, 367.
[6] [2001] 1 AC 132 (Lord Millett).

Keefe v Law Society of New South Wales **(1998) NSW SC:**

Facts
- Keefe, a solicitor, misapplies client money for private purposes
- The misappropriation is discovered, and the Law Society suspends him from practice
- However, his account does not now possess sufficient funds to meet all the clients' claims for recovery against him

Issue
- How are the available funds to be divided as between the entitled beneficiaries?

Decision
- The Court refuses to apply *Clayton's Case*, instead applying Lord Millett's principle of 'rateable distribution'
- Each client should have a rateable share of the surviving money in the account
- Thus, if client A had had $500 taken from him, and client B $250, and the account had only $150 remaining in it, client A would receive $100 and client B $50, regardless of the order in which money was withdrawn

This is a similar principle to that which applies in bankruptcy proceedings.

F *Mixing by Recipients from the Fiduciary*

This category of case concerns situations where a third party conducts the mixing, not the breaching fiduciary. If the third party is aware of the breach of duty, the third party can be in no better position than the fiduciary. This means that if the plaintiff can trace the money into the fiduciary's account, it can also trace the money into the hands of a third party with notice of the plaintiff's interest as beneficiary. However, if the third party is a *bona fide* purchaser for value without notice, tracing will not be possible.

1 *Mixing for value: tracing not possible*

If, for example, the third party receives money as consideration for the provision of goods to the breaching fiduciary, the money cannot be traced (being a good faith receipt of value). However, the beneficiary, in such a case, could trace into the goods themselves, which would be held by the fiduciary. (Here, the goods form consideration for the money.)

2 *Mixing by a volunteer: tracing possible*

If, however, the third party is an innocent volunteer — having paid no consideration for the money from the fiduciary duty, and being ignorant of any breach — who mixes the fiduciary's money with his own, a different rule will apply. The beneficiary will be rateably entitled, as against the third party, to any remaining money in the third party's account, or to any property purchased with such money.

This argument was considered and accepted in *Re Diplock*.

Re Diplock **(1948) UK CA:**

Facts
- In addition to the personal claim considered previously, the beneficiaries also claim a proprietary remedy against the wrongful beneficiaries
- They argue that they could trace their entitlements into the charities' accounts
- The charities had, in good faith, mixed the estate's money into their own accounts

Issue
- Can the estate trace into the funds mixed by the recipient charities?

Decision
- The beneficiaries and charities are rateably entitled to the money in the latter's bank accounts
- They are also rateable entitled to any property purchased with that money
- An equitable lien can be imposed over the property in the beneficiaries' favour, though not a constructive trust

3 *Money used to improve the property: cannot be traced*

In *Re Diplock*, at least one hospital used beneficiary money to improve its children's wards. (Awkwardly, it also renamed them the 'Kaleb' and 'Diplock' wards.) The House of Lords held that it would be inequitable to trace into the children's wards. This is because when property is improved, it is impossible to separate the beneficiary's money in the improved property. A single brick or window pane cannot be pointed to and it said with confident, 'that was purchased with the beneficiary's money'.

An equitable lien was not granted over the property as a whole, because the precise portion of it that was the beneficiaries' money could not be identified. However, if a specific building was constructed on vacant land, the situation may be different. Mere extension (eg, a new wing) is not sufficiently discrete to create separately identifiable property belonging to the beneficiaries.

This result may also be rationalised on the basis of change of position: the hospital relied on the fact of receipt to incur debts in construction and renovation which it would not otherwise have assumed. (Of course, such a rationale must be questioned if tracing is part of the law of property, not restitution.)

4 *A note about remedies*

Beneficiaries under a constructive trust are able to compel sale of the subject property by order of the Court, subject to a discretion to disallow sale in circumstances where it would be disruptive to the occupants. This means that if a constructive trust is granted over a portion of an indivisible asset, the plaintiff–beneficiary will normally be entitled to insist upon sale to realise their interest, regardless of the defendant–fiduciary's protestations.

Alternatively, in a case like *Foskett*, where the constructive trust is over money, the plaintiffs can elect to claim their share of the money or keep it invested in the original trust.

III *Defences*

A *Good Faith Purchaser for Value without Notice*

A defendant who has received assets traceable to the plaintiff will nonetheless be entitled to retain title in those assets if they can establish an equitable defence. This will be so where, *inter alia*, the defendant is a *bona fide* purchaser of the asset for consideration without notice of the breach of fiduciary duty or the plaintiff's equitable interest in the asset.

For example, suppose a fiduciary, F, is entrusted with legal title to a Volkswagen Beetle held for the benefit of B, the beneficiary. Now further suppose that F, in breach of duty, decides to sell the car to X, who unwittingly purchases it for $30 000. B cannot trace into the car for equitable relief against X. This is because X is a purchaser, having provided value for the asset. Clearly, however, B can trace into the $30 000 received as consideration by F, and any asset subsequently acquired with it — such as a new Mercedes — assuming the money has not been dissipated.

B *Dissipation*

Tracing ends at the point assets are dissipated. This means that if the defendant, having received assets from a breaching fiduciary, has already dissipated them, tracing will not be available to the principal.

Dissipation can occur in several ways:

- Consuming the asset (eg, setting off the fireworks; drinking the wine);
- Gifting the asset to unidentifiable parties (eg, donating the money to beggars);
- Transferring the asset to unreachable parties (eg, moving the money to a Swiss bank account);
- Gambling the asset (eg, gambling the money away at a casino in Rio de Janeiro);
- Spending the asset by distributing it to many recipients (eg, going on an overseas holiday; throwing a lavish party); *et cetera*.

This suggests that an honest but voluntary recipient of money dubious in origin should quickly spend the money for some irreversible purpose, or wash their hands of it in some other way.

However, although the third party defendant may have no money capable of being traced, they may still be personally liable for knowing receipt under the first limb of *Barnes v Addy*, if their suspicions are sufficiently raised or if, in the circumstances, a reasonable person would have known what was going on. Whether this personal liability may be established will depend on the standard of knowledge required of the defendant, and the extent of his or her actual knowledge.

C *Payment of a Debt*

If the third party defendant has used the fiduciary's assets to repay a debt, it will not be traceable by the plaintiff. This is because money used to discharge a debt cannot be traced (*Re Diplock*). In *Re Diplock*, this was held to be the case in relation to both unsecured (eg, ordinary loans) and secured (ie, mortgaged) debts.

The issue arose in *Re Diplock* because some money was also given to the Hermitage Craft School, and the money used to pay off debts. The Court of Appeal held, and the House of Lords confirmed, that it is impossible to trace into the payment of a debt.

The rule in *Re Diplock* remains controversial. For example, Lionel Smith, a leading Canadian tracing scholar, argues that tracing should not end upon payment of a debt. Instead, tracing into debts should be possible; the Court should simply ask, 'how was the debt incurred?' If the debt was incurred prior to the distribution, and used to purchase fixed asses, the beneficiaries should be entitled to a rateable share.

If, for example, X incurred the debt by acquiring an asset under contract — for example, the Volkswagen — the plaintiff should be able to trace into that asset notwithstanding that the assets the subject of the fiduciary relationship have since been used to discharge the debt to which it was held subject. Thus, instead of tracing into the third party, the tracing can 'jump' (whether by subrogation, or otherwise) directly to the freestanding asset acquired as a result of discharging the debt. This is an example of backward tracing (since X may have purchased the car prior to receiving the assets of the fiduciary). Such an approach therefore poses problems for continuity of title.

Payment of a secured debt is also possible. This will be necessary if the fiduciary assets are applied to lessen or discharge a mortgage over a home. For example, other money in *Re Diplock* was paid to the Leaf Homeopathic Hospital, which used the money to pay off a mortgage. The Court held that it was not possible to trace into the payment of a secured debt (the mortgage). This result has also been criticised as denying the beneficiaries the chance to take over the mortgage by way of subrogation, an equitable remedy that allows a party to 'stand in the shoes of' another.

In Australia, the Supreme Court of New South Wales permitted tracing of this nature in *Gertsch v Atsas*. In that case, the Court allowed subrogation in lieu of tracing, holding that the true beneficiaries were entitled to take over a mortgage as if they were mortgagees of the house, so that the wrongfully received money became owing to them, despite the mortgagor having satisfied its debt to the bank.

Gertsch v Atsas **(1999) NSW SC:**

<u>Facts</u>

- X's will is forged; X dies
- Pursuant to the forged will, Hamilton is wrongly paid \$100 000
- Hamilton uses \$68 000 to repay the mortgage over her home and dissipates the remainder

<u>Issue</u>

- Can the estate trace into the \$68 000 paid by Ms Hamilton to the bank?

<u>Reasoning</u>

- The beneficiary stands in the shoes of the original lender by subrogation
- Thus, instead of owing \$68 000 to the bank, Ms Hamilton now owes that amount to the beneficiary
- This is an example of subrogation, an equitable doctrine allowing one party to be deemed substituted for another

<u>Decision</u>

- Application of the fiduciary assets to discharge the secured loan is not fatal to tracing

D *Where Inequitable to Grant a Proprietary Remedy*

Re Diplock holds still further surprises. A hospital was one of the 137 charities to receive a portion of the Diplock estate under the invalid will. This hospital used that money to make improvements to the children's ward, including constructing an extension.

The hospital was personally liable to repay the wrongfully received money; however, tracing into the improvements was not possible. This defence is not a result of unfairness or injustice. Rather, at a conceptual level, it is impossible to identify with any precision the property into which the plaintiff's money went (see above).

However, *Re Diplock* is authority for the proposition that tracing may be refused when it is inequitable to repay the money received. This is essentially synonymous to the defence of change of position. References to 'inequitability' have largely been interpreted as references to change of position — the language of fairness is simply being substituted for the language of unjust enrichment.

E *Good Faith Change of Position*

Arguably, change of position should only be recognised as a defence to tracing if its conceptual foundation lies in unjust enrichment. If the basis of tracing is simply property law, strict liability applies: return of property possessed under invalid title can be compelled regardless of the use to which it is put by its possessor. If, as Lord Millet has stated, tracing is part of property law, there can be no role for the defence of change of position.

An alternative (though perhaps questionable) view is that tracing derives from the law of unjust enrichment. A defence of change of position would therefore be defensible. This is because the essence of the plaintiff's claim is that the third party has been unjustly enriched at their expense. In the law of unjust enrichment, change of position is a complete defence; as where, for example, the unjustly enriched recipient of fiduciary assets has in good faith applied them to some purpose such as to be no longer enriched. Accordingly, the defence of change of position applies if this is the conceptual foundation of tracing.

In any event, so much appears to have been accepted by the Supreme Court of New South Wales in *Gertsch v Atsas*.

Gertsch v Atsas (1999) NSW SC:

Facts

- In addition to the conduct described above, the wrongful recipient, Ms Hamilton, also gives up her job as a taxi driver to become a university student

Issue

- Has Ms Hamilton changed her position to her detriment such as to entitle her to retain the wrongfully received proceeds?

Decision

- Yes, this amounts to a good faith change of position, to her detriment

- Becoming a university student is arguably not a long-term detriment since it enhances employability
- However, in terms of her immediate wealth, she is poorer

The Court simply appears to have presumed that change of position is available as a defence to a tracing claim.

The availability of change of position as a defence to tracing has been neither confirmed nor denied by the High Court of Australia. Its availability seems likely to depend on the view that is taken of its conceptual basis. The High Court will probably side with Lord Millett's property law view rather than a restitution approach. Therefore, the defence is unlikely to apply.

In the United Kingdom, an authoritative statement of the law of change of position has been given. The issue arose in relation to a claim involving tracing, but at a time when the basis was regarded as restitutionary. The case is *Lipkin Gorman (a firm) v Karpnale Ltd* ('*Lipkin Gorman*'), and concerns the liability of a recipient casino to return property misappropriated and subsequently gambled by the plaintiff's agent. The casino's argument that it changed its position on faith of the gambler's bets is rejected.

Lipkin Gorman (a firm) v Karpnale Ltd (1991) HL:

Facts
- Mr Cass is a partner in Lipkin Gorman, a firm of solicitors
- Cass misappropriates funds from the firm's client account and exhausts much of it while gambling at 'the Playboy Club', a private casino owned by Karpnale Ltd
    - Some £174 745 are gambled at the casino
    - £20 050 of this money is from Cass' own account
    - The remaining £154 695 was stolen from the client account
    - The casino is clearly a volunteer, not having given consideration for the money
- The firm seeks recovery of the money from the casino; otherwise it must replenish the client account itself
- The firm argues that it has an *in personam* right to recovery of the money from the casino

Issue
- Can the firm trace into the casino's bank account?

Reasoning
- Lord Goff:
    - In misappropriating the money from the client account, Cass committed a clear breach of fiduciary duty
    - The fact that Cass may have mixed the client money in his own account before gambling it is unproblematic
        - 'even if legal title to the money did vest in Cass immediately on receipt, nevertheless he would have held it on trust for his partners, who would accordingly have been entitled to trace it in equity into the hands of the respondents.'
        - The enrichment of the club was at the expense of the solicitors
    - When Cass lost the £154 695 gambling at the respondent's casino, he completed a gift of that amount to the club
    - The casino's argument is that it had accepted the money and innocently changed its position to its detriment by allowing Cass to gamble and paying him

winnings
- A *bona fide* change of position is a good defence to a tracing claim, providing such a change makes it in equitable to require restitution (ie, there is a relevant detriment)
- Here, however, there has not been any detriment

- Lord Templeman:
  - 'The club has not suffered any detriment. If the club pays £154 695 to the solicitors as a result of this appeal, the club will be in exactly the same position which [it] would have obtained if Cass had not gambled away the solicitors' money. It is true that the club would have been in a better position if Cass had been gambling away his own money, but that plaintiff observation does not entitle the club to retain the solicitors' money by which the club remains unjustly enriched to the extent of £154 695.'

Decision
- The casino's change of position defence is to be rejected
- The firm is entitled to recover the entire amount received by the casino from Mr Cass, less the amount paid by the club to Mr Cass in winnings

IV *Remedies*

A *Introduction*

As Lord Millett noted in *Foskett v McKeown*, it should be borne in mind that tracing is neither claim nor remedy, but rather a process of establishing proprietary entitlement.

For this reason, the following remedies are more accurately described as remedies to a property law claim — whether at law or in equity — rather than consequent upon successful tracing. Although tracing is necessary to establish the rights required to support these remedies, it is not sufficient without an independent cause of action.

B *Election to Take Property*

The plaintiff may elect to take property in the defendant's hands. This is a narrow remedy; it only applies in circumstances where the plaintiff's property has been exchanged for that of another party. For this reason, it is rarely used.

For example, in *Taylor v Plumer*, the plaintiff's money was misapplied to gold bullion instead of shares. The plaintiff's property (money) was exchanged for another kind of property (gold). Consequently, the plaintiff could, if he chose, elect to take the gold. This is useful if the value of the exchanged property has risen relative to the value of the original property.

C *Equitable Lien*

Where property has fallen in value, an equitable lien may be imposed over the defendant's remaining assets, including any property held. It amounts to an order to sell off the property, entitling the plaintiff to return of the value of their property.

If the value of the defendant's assets is less than the amount of which the plaintiff has been deprived, the lien will only apply to the extent that it can be satisfied by sale of the property. Liens are not 'equitable magic' capable of creating value. The difference between the quantum of the lien and the amount owed will be made up by way of a personal remedy. This is an example of a situation where tracing is insufficient to secure recovery.

Further, because liens are intended to provide security, it does not make sense to seek their imposition over floating assets, such as shares or debentures. Liens should only be sought over fixed and stable assets, preferably real property.

D *Account of Profits*

If the plaintiff's asset has appreciated in value while in the hands of the defendant, an account of profits may be obtained by the plaintiff. This will entitle it to the full (increased) value of the property. Value is assessed as of the date of judgment (but not post-judgment).

An account of profits will often be secured by an equitable lien. See, eg, *Scott v Scott*.

E *Constructive or Resulting Trust*

The most popular remedy is that of constructive trust. It entitles a plaintiff to a proportionate share of property held by the defendant. The actual value of the share will vary with the value of the asset. It is useful where the value of the property is likely to increase after judgment.

See, in effect, *Foskett*, where what in essence was a constructive trust was granted over the life insurance policy in proportion to the beneficiaries' $2/5^{th}$ share. Although the remedy was couched in terms of an account of profits, the beneficiaries' interest was more akin to a constructive trust.

Some scholars argue that the trust imposed as a tracing remedy is better classified as a resulting trust. To some extent, however, the remedy's classification is irrelevant, as its incidents are well known.

V *Hypothetical*

A *Problem 6*

1 *Is there a fiduciary relationship?*

(a) Presumed

- Business partners
    - Formal agreement is missing
- Trustee of trust money ($2000)
    - Is it supposed to be a trust account?
    - Is he trustee of that account?
    - This argument is possible
- Agent–principal
    - Weaker
- Employee–employer
    - Very weak since they share the profits

(b) Factual

- Horizontal relationship: similar to a joint venture
    - *UDC v Bryan* test applies: no contract signed, so test is 'mutual trust and confidence'
    - Factors:
        - Lack of formality suggests trust
            - Restaurant meeting
            - Napkin notes
            - However, this may militate against a fiduciary relationship — didn't protect their interests but could have (*LAC Minerals v Corona* minority)
        - Lack of consultation with solicitors
        - Handing over money without any security
        - Friends
        - However, Andrew must approve changes to the business plan
            - Suggests lack of trust
    - Other tests: *Hospital Products*
        - Undertaking
            - Bill has undertaken to run the business and give her a share of the profits
        - Vulnerability
            - Clearly established: Bill has the capacity to affect Andrea's interests
- There is probably a factual fiduciary relationship

2 *The joint account money*

(a) Breach of fiduciary duty

- Clear breach (*Chan v Zacharia*; *Boardman v Phipps*)
    - No profit: appropriated for his own purposes
    - No conflict: didn't put it into the account as promised

- Equitable compensation, a personal remedy, is available to compensate A for the breach of duty

(b) Account of profits

- Better than compensation ($2000) since B made a profit
- Personal remedy
- Secure by charge or lien?
- Elect to take shares?
- Must show connection between money (tracing relevant)
- **Mixing**
    - *Re Hallett's Estate*: B uses his money first
        - Only $500
    - *Re Oatway*: best result would be to deem $2000 of the $2500 purchase of shares to have been derived from A's funds
        - Presumption is that the successful investment belongs to the principal
        - Thus, A has a 4/5th share in the shares (*Scott*; *Foskett*: entitled to a prorated interest)
    - Remedy
        - Account of profits assessed at the date of judgment: $4000, secured by an equitable lien
        - Alternatively, elect to take 4/5ths of the shares
        - Or a constructive trust over the shares (since they might further rise in value)
            - Doubled in value; likely to continue rising
            - However, if the market is uncertain and the shares could fall in value, sale of the shares should be compelled quickly so that A can realise her $4000
            - This remedy is riskier than the others, since A bears the risk that the market will fall

- Alternatively:
    - Since fiduciaries should not benefit at all from their breaches, B should be entitled to the full increase in value of the shares
    - A must simply return the $500 of B's money used to purchase them
    - Not directly argued in *Scott v Scott*, but possible in a theoretical sense
    - This would vest a full beneficial in the asset by way of constructive trust
    -

- Bill would argue:
    - Debit the fiduciary with all fund dissipation (*Oatway* and *Hallett*)
    - However, no dissipation here
    - So the fiduciary debits their own money first
    - Thus, $1000 of Bill's money went into the shares, then $1500 of A's money
    - Consequently, A would only have a 3/5th share in compensation, or an election to take that share
    - However, weaker since cases prefer to deliver the best outcome possible for the fiduciary
    - (And A would also be entitled to the $500 still in B's bank account, which would be deemed to be hers)

- Allowance for knowledge and skill: choosing the shares
    - Likely to be very small here

(c) Constructive trust

-

3 *The Brunswick business*

(a) **Breaches: accepting the $10 000**

- Bribery?
    - Impacts upon remedies
    - *Lister*: no proprietary remedy over money
        - Can obtain a personal remedy
        - However, cannot trace into its proceeds
        - Ie, cannot trace into the building
        - This would mean that no proprietary remedy would be available for the worst kind of breach; it may even allow the breaching fiduciary to retain some benefit from their breach
    - *Reid*: available as per normal
- Probably not a bribe: already accepted the contract, payment came afterwards
- No profit
    - Profiting from his position as fiduciary
    - Came to him in that capacity
    - Clear breach of no profit rule

(b) **Breaches: appropriating the café's profits**

- Clear breach
    - No conflict, no profit rules

(c) **Remedies**

- A is able to obtain recovery of the profits and royalty payment to which A is entitled

    - If a remedy is available (applying *Reid*), A will be entitled to a prorated share in the bribe ($5000)
- Secure by lien or charge
- She can trace into the actual building to secure such a remedy
    - Unclear whether the building has increased in value
- A may be entitled to a constructive trust over the building
    - Building was purchased entirely with the $10 000 and the profits

(d) **Scope of the joint venture: does it encompass the Brunswick profits?**

- Is setting up the new business a breach?
    - What is the scope and ambit of the duty?
    - Doesn't include not carrying on any other food businesses
- Will the Brunswick restaurant be in direct competition with the Carlton café?
    - Real and sensible possibility of conflict
    - Different markets
        - But both food businesses
    - Different suburbs
        - But neighbouring
        - Cf another city
- Does it amount to a misuse of B's position as fiduciary?
    - Not an opportunity unique to the position
    - However, did use the trust assets

(e) **Remedy**

- *Warman*: carrying on a business isn't like other remedies
    - Constructive trust probably not possible
    - Especially since it was successful largely due to B's own skills
- Eg, account of profits for a specific period of operations
- To what extent is the Brunswick restaurant a profit of
    - The building was completely derived from the breach
    - However, B's knowledge and goodwill is his own

- Side note — *Say-Dee*:
    - Should the constructive trust be in favour of the joint venture (ie, shared in proportion to their shares in the business)?
    - It was in *Say Dee*
    - Even though some of the remedies were against B, the others may be held jointly
    - See *Say Dee*

4 Conclusion

(a) Andrea has equitable claims to:

- The profits misappropriated from the café business in her share by way of constructive trust

- A half share of the $10000 payment by way of constructive trust, possibly traceable into the warehouse in Brunswick
- The initial investment money, as accrued
- Possibly, the Brunswick profits

B *Remedy Checklist*

1 *Personal remedies*

What personal remedies does the principal have against the breaching fiduciary?

(a) Compensation
(b) Account of profits
(c) Rescission
(d) Effect of tracing on personal remedies

Tracing can be used to secure a personal remedy by equitable charge or lien.

2 *Proprietary remedies*

What proprietary remedies does the principal have against the breaching fiduciary?

(a) Tracing

To obtain a proprietary remedy, it must be possible to trace the property into their hands. This will not be possible if it has been dissipated.

(i) Election to take property (if fungible)

- Only if the property is worth more than the loss

(ii)

(b) Constructive trust
(c) Etc

3 *Third party remedies*

For each third party, ask:

(a) Is there a personal remedy?

- *Barnes v Addy*
  - First limb
  - Second limb
- *Re Diplock* (personal claim)

(b) Is there a proprietary remedy?

- Is there tracing available against them?

    - Even if no mental element, can still trace
    - Eg, third party volunteers
- Effect of tracing on personal remedy
    - Secure the personal claim
    - Slightly more generous tracing rules

Note different mental standards to be applied to each test for the various remedies. There is also some overlap between doctrines for the defences (eg, BFPFVWN). Note interaction between tracing and *Say Dee*, and knowledge and 'notice'.