Trusts
Fall Term 2017

Lecture Notes – No. 17

ARE THIRD PARTIES LIABLE TO SUFFER A REMEDY?

In ***Barnes v Addy* (1874) L.R. 9 Ch. App. 244**, Lord Selborne L.C. described two distinct equitable actions available against a third party (i.e. someone outside the trust) popularly known as **'knowing receipt'** (available against a third party possessed of trust property in his or her personal capacity; i.e. not as an agent) and **'knowing assistance'** (against a third party who is an accessory to breach of trust of fiduciary duty).

- In both the areas of 'knowing receipt' and 'knowing assistance', the courts and commentators are drawn between two positions: are these forms of liability 'wrongs' (based on some degree of fault) or restitutionary responses based on unjust enrichment (favouring strict liability, subject to a defence of 'change of position')?

- The claim of a bona fide purchaser for fair value without notice of the trust supersedes claims by the trustee or beneficiary; *Nelson* v *Larholt* [1948] 1 KB 339; *Macmillan Inc* v *Bishopsgate Investment Trust (No 3)* [1995] 3 All ER 747.

- The third party in receipt of trust property disposed of in breach of trust by the trustee must be distinguished from the liability of a third party as a 'trustee de son tort'; that is, a third party who is a stranger to the trust and who intermeddles with trust property and does acts characteristic of a trustee and commits a breach of trust. The *trustee de son tort* is personally liable to account to B as well as to hold any trust property on a constructive trust; *Mara* v *Brown* [1896] 1 Ch 199; *Williams-Ashman* v *Price & Williams* [1942] Ch 219; *Re Barney* [1892] 2 Ch 265.

Third Parties in Possession

Traditionally, the liability of a stranger possessed of trust property to hold as a constructive trustee for the rightful beneficiary has been thought to be bound up with considerations of knowledge of the disposition of the trust property in a breach of trust. Thus, cases have concerned themselves with actual, implied and constructive knowledge (whether received at the time of the actual receipt or thereafter) as to the status of the property obtained as being associated with breach of trust or fiduciary duty.

Determination of a sufficient degree of knowledge for equity to consider the conscience of the third party as affected has been highly problematic; in particular, the degree to which suspicion alone would suffice as knowledge has been a source of great uncertainty. Thus it has been well recognised in recent years that the evolution of knowledge-based tests of third party fault have resulted in a complex series of technical considerations that have caused considerable frustration. An influential case has been *Baden v Societe Generale pour Favoriser le Developpement du Commerce et de l'Industrie en France SA* [1993] 1 WLR 509, 575-576 (Ch) where Peter Gibson J classified knowledge as (i) actual knowledge; (ii) wilfully shutting one's eyes to the

obvious; (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make; (iv) knowledge of circumstances which would indicate the facts to an honest and reasonable man; (v) knowledge of circumstances which will put an honest and reasonable man on inquiry; see also *El Ajou v Dollar Land Holdings plc* [1994] 2 All ER 685, 700 (CA). All of this is very redolent of criminal law.

One judge characterized this area as being one that has become inordinately technical and over-theorized inquiries into knowledge-based personal fault have tended towards ‘tortuous convolutions’ along a ‘gradually darkening spectrum where the differences [of states of mind constituting sufficient knowledge] are of degree and not kind.’ In response, much scholarly work has been done in recent years to rationalize the area to provide for clearer and simpler operation. In particular, the question that has been asked whether the liability of the stranger should be strict.

Citadel General Assurance Co. v. Lloyds Bank Canada
[1997] 3 S.C.R. 805

An insurance agent sold policies underwritten by the plaintiff insurer. The agent collected premiums on behalf of the insurer, and deposited them in a general account with the defendant bank. The bank was aware that insurance premiums were being deposited into the agent's account. The agent's parent company also banked with the bank. The bank received instructions from the parent company's signing officers, who were identical to the agent's signing officers, to transfer all funds in the agent's account to the parent company's account at the end of each business day. The transfer of funds between the accounts reduced the parent company's overdraft. The agent failed to remit to the insurer premiums collected on the insurer's behalf. The agent and the parent company ceased carrying on business. The insurer brought an action against the bank for the outstanding premiums. Liability against the bank was found and a constructive trust in favour of the insurer ordered.

The rule that emerges is that there are three requisite elements in order to obtain a remedy: the property is disposed of in breach of trust or fiduciary obligation; the defendant beneficially receives the property or further property into which the trust property can be traced; the defendant has at least ‘knowledge of facts sufficient to put a reasonable person on notice or inquiry.’

Per La Forest J.

> 24 The only basis upon which the Bank may be held liable as a constructive trustee is under the "knowing receipt" or "knowing receipt and dealing" head of liability. **Under this category of constructive trusteeship it is generally recognized that there are two types of cases. First, although inapplicable to the present case, there are strangers to the trust, usually agents of the trustees, who receive trust property lawfully and not for their own benefit but then deal with the property in a manner inconsistent with the trust. These cases may be grouped under the heading "knowing dealing". Secondly, there are strangers to the trust who receive trust property for their own benefit and with knowledge that the property was transferred to them in breach of trust. In all cases it is immaterial whether the breach of trust was fraudulent;** see *Halsbury's Laws of England* (4th ed. 1995), vol. 48, at para. 595; Pettit,

supra, at p. 168; Underhill and Hayton, *Law Relating to Trusts and Trustees* (14th ed. 1987), at p. 357. The second type of case, which is relevant to the present appeal, raises two main issues: the nature of the receipt of trust property and the degree of knowledge required of the stranger to the trust.
25 Liability on the basis of "knowing receipt" requires that strangers to the trust receive or apply trust property for their own use and benefit; see *Agip (Africa) Ltd. v. Jackson* (1989), [1990] 1 Ch. 265 (Eng. Ch. Div.), aff'd [1992] 4 All E.R. 451 (Eng. C.A.); *Halsbury's Laws of England, supra,* at paras. 595-96; Pettit, *supra,* at p. 168. As Iacobucci J. wrote in *Air Canada v. M & L Travel Ltd., supra,* at pp. 810-11, the "knowing receipt" category of liability "requires the stranger to the trust to have received trust property in his or her personal capacity, rather than as an agent of the trustees". In the banking context, which is directly applicable to the present case, the definition of receipt has been applied as follows:

The essential characteristic of a recipient ... is that he should have received the property for his own use and benefit. That is why neither the paying nor the collecting bank can normally be made liable as recipient. In paying or collecting money for a customer the bank acts only as his agent. It sets up no title of its own. It is otherwise, however, if the collecting bank uses the money to reduce or discharge the customer's overdraft. In doing so it receives the money for its own benefit.... [Footnotes omitted.]; P.J. Millett, "Tracing the Proceeds of Fraud" (1991), 107 *L.Q.R.* 71, at pp. 82- 83.

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30 Nonetheless, the respondents' arguments reflect a difficulty with the traditional conception of "receipt" in "knowing receipt" cases. **In my view, the receipt requirement for this type of liability is best characterized in restitutionary terms. In *International Corona Resources Ltd. v. LAC Minerals Ltd.,* [1989] 2 S.C.R. 574 (S.C.C.), at p. 669, I stated that a restitutionary claim, or a claim for unjust enrichment, is concerned with giving back to someone something that has been taken from them (a restitutionary proprietary award) or its equivalent value (a personal restitutionary award).** As well, in *Air Canada v. British Columbia,* [1989] 1 S.C.R. 1161 (S.C.C.), at pp. 1202-3, I stated that **the function of the law of restitution "is to ensure that where a plaintiff has been deprived of wealth that is either in his possession or would have accrued for his benefit, it is restored to him. The measure of restitutionary recovery is the gain the [defendant] made at the [plaintiff's] expense."** ...

48 Given the fundamental distinction between the nature of liability in assistance and receipt cases, it makes sense to require a different threshold of knowledge for each category of liability. In "knowing assistance" cases, which are concerned with the furtherance of fraud, there is a higher threshold of knowledge required of the stranger to the trust. Constructive knowledge is excluded as the basis for liability in "knowing assistance" cases; see *Air Canada v. M & L Travel Ltd. National Westminster Bank Ltd., supra,* at pp. 811-13. However, **in "knowing receipt" cases, which are concerned with the receipt of trust property for one's own benefit, there should be a lower threshold of knowledge**

> **required of the stranger to the trust. More is expected of the recipient, who, unlike the accessory, is necessarily enriched at the plaintiff's expense. Because the recipient is held to this higher standard, constructive knowledge (that is, knowledge of facts sufficient to put a reasonable person on notice or inquiry) will suffice as the basis for restitutionary liability.** Iacobucci J. reaches the same conclusion in *Gold National Westminster Bank Ltd., supra,* where he finds, at para. 46, that a stranger in receipt of trust property "need not have actual knowledge of the equity [in favour of the plaintiff]; notice will suffice".
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> 50 Some commentators go further and argue that a recipient may be unjustly enriched regardless of either a duty of inquiry or constructive knowledge of a breach of trust. According to Professor Birks, a recipient of misdirected funds should be liable on a strict, restitutionary basis. In his article "Misdirected funds: restitution from the recipient", [1989] *L.M.C.L.Q.* 296, he argues that a recipient's enrichment is unjust because the plaintiff did not consent to it, not because the defendant knew that the funds were being misdirected. In particular, he writes, at p. 341, that "[t]he 'unjust' factor can be named 'ignorance', signifying that the plaintiff, at the time of the enrichment, was absolutely unaware of the transfer from himself to the defendant". Birks, however, lessens the strictness of his approach by allowing a defendant to take advantage of special defences, including a defence arising out of a bona fide purchase for value. (See also P. Birks, "Overview: Tracing, Claiming and Defences", in P. Birks, ed., *Laundering and Tracing* (1995), 289, at pp. 322 *et seq.)*
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> 51 In my view, the test formulated by Professor Birks, while not entirely incompatible with my own, may establish an unjust deprivation, but not an unjust enrichment. It is recalled that a plaintiff is entitled to a restitutionary remedy not because he or she has been unjustly *deprived* but, rather, because the defendant has been unjustly *enriched,* at the plaintiff's expense. **To show that the defendant's enrichment is unjustified, one must necessarily focus on the defendant's state of mind not the plaintiff's knowledge, or lack thereof. Indeed, without constructive or actual knowledge of the breach of trust, the recipient may very well have a lawful claim to the trust property. It would be unfair to require a recipient to disgorge a benefit that has been lawfully received. In those circumstances, the recipient will not be unjustly enriched and the plaintiff will not be entitled to a restitutionary remedy.**

Third Party Accessories

While the liability of a recipient of property transferred in breach of trust is receipt- based, the liability of a stranger who procures or assists in breach of fiduciary duty is not. Rather, it is conduct-based fault that is at issue here, and the fault of the stranger-accessory is tested without reference to any underlying fault on the part of the trustee who breaches her obligation. It is an independent form of primary liability in its own right which results in an order for the third party to compensate the beneficiary and/or disgorge his or her own profit flowing from the breach.

Air Canada v. M & L Travel Ltd.
[1993] 3 S.C.R. 787

Here a travel agency was obliged to hold the proceeds from its sale of Air Canada tickets in trust for the airline, but the agency breached its trust and used the proceeds to reduce its indebtedness to a bank. There was little question that a trust existed rather than a simple debt given that the travel agency treated the money not as its own (until the breach) but as the beneficial property of the airline.

Per Iacobucci J:

> 34 Second, strangers to the trust can also be personally liable for breach of trust if they knowingly participate in a breach of trust. The starting point for a review of the bases of this kind of personal liability is *Barnes v. Addy,* supra, which involved an estate, for which three trustees had been designated by the testator. The will allowed for the appointment of new trustees without the consent of any other party, but did not allow for a decrease in the number of trustees. Two of the trustees died and a rift developed between the family and the third trustee, who wished to retire. He instructed his solicitor to prepare an instrument appointing Barnes, who was the husband of one of the beneficiaries, as sole trustee. The solicitor advised him against having only one trustee, but prepared the instrument on the instructions of his client. Barnes' solicitor approved the appointment. Barnes invested the trust funds for his own purposes and [page810] went bankrupt. The beneficiaries sued the previous trustee, his solicitor and Barnes' solicitor for breach of trust. The action against the solicitors was dismissed on the basis that they had no knowledge of, or any reason to suspect, a dishonest design in the transaction, and that they did not receive any trust property.
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> 35 Lord Selborne L.C., at pp. 251-52, set out the ways in which a non-trustee can become responsible for a trust:
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>> Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility. That responsibility may no doubt be extended in equity to others who are not properly trustees, if they are found either making themselves trustees de son tort, or actually participating in any fraudulent conduct of the trustee to the injury of the cestui que trust. But, on the other hand, strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions, perhaps of which a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees.
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> In addition to a trustee de son tort, there were traditionally therefore two ways in which a stranger to the trust could be held personally liable to the beneficiaries as a participant in a breach of trust: as one in receipt and chargeable with trust property and as one who knowingly assisted in a

dishonest and fraudulent design on the part of the trustees. The former category of constructive trusteeship has been termed "knowing receipt" or "knowing receipt and dealing", while the latter category has been termed "knowing assistance".

...

58 **It must be remembered that it is the nature of the breach of trust that is under consideration at this point in the analysis, rather than the intent or knowledge of the stranger to the trust. That is, the issue here is whether the breach of trust was fraudulent and dishonest, not whether the appellant's actions should be so characterized. *Barnes v. Addy* clearly states that the stranger will be liable if he or she knowingly assisted the trustee in a fraudulent and dishonest breach of trust. Therefore, it is the corporation's actions which must be examined. The appellant's actions will also be relevant to this examination, given the extent to which M & L was controlled by the defendant directors. The appellant's conduct will be more directly scrutinized when the issue of knowledge is under consideration. It is unnecessary, therefore, to find that the appellant himself acted in bad faith or dishonestly.**

59 **Where the trustee is a corporation, rather than an individual, the inquiry as to whether the breach of trust was dishonest and fraudulent may be more difficult to conceptualize, because the corporation can only act through human agents who are often the strangers to the trust whose liability is in issue. Regardless of the type of trustee, in my view, the standard adopted by Peter Gibson J. in the *Baden, Delvaux* case, following the decision of the English Court of Appeal in *Belmont Finance,* supra, is a helpful one. I would therefore "take as a relevant description of fraud 'the taking of a risk to the prejudice of another's rights, which risk is known to be one which there is no right to take'." In my opinion, this standard best accords with the basic rationale for the imposition of personal liability on a stranger to a trust which was enunciated in In *re Montagu's Settlement Trusts,* supra, namely, whether the stranger's conscience is sufficiently affected to justify the imposition of personal liability.** In that respect, the taking of a knowingly wrongful risk resulting in prejudice to the beneficiary is sufficient to ground personal liability. This approach is consistent with both lines of authority previously discussed.

PROPRIETARY REMEDIES AND TRACING

> 'It is an undoubted principle of this court that as between a *cestui que trust* and trustee and all parties claiming under the trustee, otherwise than by purchase for valuable consideration without notice, all property belonging to a trust, however much it may be changed or altered in its nature or character, and all the fruits of such property, whether it is in its original or its altered state, continues to be subject to or affected by the trust.'
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> \- *Pennell v. Defell* (1853), 4 DeG, M & G 372, 388 (Ch) per Turner LJ

'Tracing' in Equity, 'Following' in Law: Is There Still a Distinction?

Consider a simple example - a trustee has transferred the trust property to a third party in breach of trust.

- <u>If the third party is a bona fide purchaser for value without notice of the trust</u>, the beneficiary can only sue the trustee for breach of trust and seek a personal remedy (an order to pay compensation). The third party purchaser has rights good against the world.

- <u>If the third party is not a bona fide purchaser for value without notice of the trust and retains the property</u>, the trustee (as the legal owner of the trust property) can sue in law to have the trust property returned to him or her. The form of the action will vary (e.g. conversion) and the third party defendant may have defences to the action. The remedy can be an order for possession in law or damages (again determined by the nature of the action and the circumstances). If the trust property has changed form (e.g. money was transferred and the third party has purchased a car), the trustee can *follow* his or her interest into this 'direct substitute'.

- <u>If the third party is not a bona fide purchaser for value without notice of the trust and has taken the trust property (say money) and mixed it with other money (say in a bank account)</u>, then the title to the property has been extinguished – it is no longer precisely identifiable and there can be no common law action brought based on title. Equity, however, can intervene where there is an equitable wrong (say breach of fiduciary duty) – the beneficiary (holding the beneficial interest) can *trace* his or her equitable interest into the mixed fund and seek a proprietary remedy (e.g. a constructive trust) to regain his or her interest. **The tracing rules are a process rather than a remedy.** Given that the beneficiary's money may have mixed with the money of other innocents, there can be quite complex calculations that have to be made – but the principle is the same.

This traditional approach relies on a fiction – the division of equitable and legal interests. Recent cases have asserted that this division between law and equity no longer is justifiable and overly-complicates an already complicated question. Thus, in **Foskett v. McKeown [2001] 1 AC 102**, one can note the following dicta:

Lord Steyn said:

> In arguing the merits of the proprietary claim counsel for the purchasers from time to time invoked "the rules of tracing". By that expression he was placing reliance on a corpus of supposed rules of law, divided into common law and equitable rules. **In truth tracing is a process of identifying assets: it belongs to the realm of evidence. It tells us nothing about legal or equitable rights to the assets traced. In a crystalline analysis Professor Birks… explained… that there is a unified regime for tracing and that "it allows tracing to be cleanly separated from** the business of asserting rights in or in relation to assets successfully traced". Applying this reasoning Professor Birks concludes:
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>> "that the modern law is equipped with various means of coping with the evidential difficulties which a tracing exercise is bound to encounter. The process of identification thus ceases to be either legal or equitable and becomes, as is fitting, genuinely neutral as to the rights exigible in respect of the assets into which the value in question is traced. The tracing exercise once successfully completed, it can then be asked what rights, if any, the plaintiff can, on his particular facts, assert. It is at that point that it become relevant to recall that on some facts those rights will be personal, on others proprietary, on some legal, and on others equitable."
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> I regard this explanation as correct. It is consistent with orthodox principle. It clarifies the correct approach to so-called tracing claims. It explains what tracing is about without providing answers to controversies about legal or equitable rights to assets so traced.

In the same case, Lord Millett said:

> **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. 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. That will depend on a number of factors including the nature of his interest in the original asset. He will normally be able to maintain the same claim to the substituted asset as he could have maintained to the original asset. If he held only a security interest in the original asset, he cannot claim more than a security interest in its proceeds. But his claim may also be exposed to potential defences as a result of intervening transactions...**
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> 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… There is certainly no logical justification for allowing any distinction between them to produce capricious results in cases of mixed substitutions by insisting on the existence of a

> fiduciary relationship as a precondition for applying equity's tracing rules. The existence of such a relationship may be relevant to the nature of the claim which the plaintiff can maintain, whether personal or proprietary, but that is a different matter… This is not, however, the occasion to explore these matters further…

[Millett LJ, as he was then, expressed similar sentiments in **Trustee of Property of FC Jones and sons (a firm) v Jones [1996] 3 WLR 703 (CA)**. The sentiment has gained some support in Canadian case law; for example, *Waxman v Waxman* (2002), 25 B.L.R. (3d) 1 (Ont Sup Ct) at para 1654; appeal dismissed, but without commenting on the point specifically, (2004), 44 B.L.R. (3d) 165, paras. 581-584. Moreover, the 'flexible' use of the fiduciary principle merely to allow a tracing remedy has been criticized by the Supreme Court of Canada; see *LAC Minerals Ltd. v. International Corona Resources Ltd.*, [1989] 2 S.C.R. 574, 649-51. One might note that even English jurisprudence has been inconsistent in removing the distinction is later cases. Thus, for example, one implication of *Foskett v. McKeown* is to remove the requirement that tracing proceed from breach of a fiduciary duty – later cases still use the distinction to ground a tracing remedy; see, for example, *Shalson v Russo* [2005] Ch. 281 at para. 103-104.]

What would better explain the reason that one strips the third party of the property if we abandon an insistence on an equitable wrong? Unjust enrichment.

Foskett v. McKeown
[2001] 1 AC 102 (HL)

Here a rogue trustee took monies from certain beneficiaries and used part of the monies to pay premiums on a life insurance policy. The trustee later died and not surprisingly the beneficiaries claimed for a proportionate share of the proceeds of the policy. The House of Lords (in a decision that split the law Lords 3-2) ruled that the beneficiaries were so entitled – the beneficiaries had an interest similar to that they would have enjoyed if the misappropriated money was paid into a bank account.

The following propositions can be taken from the case:

1. A beneficiary of a trust is entitled to a continuing beneficial interest in the trust property and in its traceable proceeds, and his or her interest binds everyone who takes the property or its traceable proceeds except a bona fide purchaser for value without notice.

2. If a trustee wrongfully misappropriates trust property and uses it exclusively to acquire other property for his or her own benefit:

   (a) the beneficiary has the option either to assert beneficial ownership of the proceeds or to bring a personal claim against the trustee for breach of trust and enforce an equitable lien or charge on the proceeds to secure restoration of the trust fund;

   (b) the beneficiary will normally exercise the option in the way most advantageous to himself or herself. If the traceable proceeds have increased in value and are worth more than the original asset, the beneficiary will assert his or her beneficial ownership and obtain the profit. If the traceable proceeds are worth less than the

original asset, it does not usually matter how the beneficiary exercises his or her option. The beneficiary will take the whole of the proceeds on either basis.

3. If a trustee wrongfully uses trust money to provide part of the cost of acquiring an asset, the beneficiary is entitled at his or her option either to claim a proportionate share of the asset or to enforce a lien upon it to secure his or her personal claim against the trustee for the amount of the misapplied money.

4. In a mixed fund where there are competing innocents, gains and losses are borne by the contributors proportionally. As against the wrongdoer and his or her successors, the beneficiary is entitled to locate his or her contribution in any part of the mixture and to subordinate their claims to share in the mixture until his or her own contribution is satisfied. There is no basis for subordinating the claim of one innocent contributor to the competing claims of any of the others.

Conventional Operation of the Tracing Rules

In **Re Diplock [1948] Ch 465 (Eng CA)**, a charitable gift failed but only after a substantial sum of money had already been distributed by the trustee. The beneficiaries sought proprietary remedies against third party recipients. The case is usually cited for the following proposition:

> Where a fiduciary breaches his or her obligation to the beneficiary, the beneficiary can trace his or her equitable interest in property into the hands of another and claim a proprietary remedy except where the third party is a bona fide purchaser for fair value without notice.

What happens where the trust property is mixed with the trustee's own property?

If the trust property can be separated, the trustee still holds on trust for the beneficiary (and the beneficiary can then apply to have the trustee removed).

If the trust property has become mixed such that it cannot be separated, the beneficiary can in the first instance take a charge over the whole of the mixed funds and put the trustee on an obligation to establish that part of the fund in which he or she has an interest.

- If the trustee has withdrawn money and purchased property, the beneficiary can claim a proprietary remedy against the mixed fund on the presumption that the trustee withdrew his own money first (rather than the beneficiary's money); **Re Hallett (1880) 13 Ch D 696.**

- If the trustee has withdrawn money and purchased property, the beneficiary can also seek a proprietary remedy (a charge) against that property; **Re Oatway [1903] 2 Ch 356**. In *Foskett v. McKeown* [2001] 1 AC 102, it was held that the beneficiary need not just take a charge, he or she can claim and take a proportional share of the new asset (based on his proportional entitlement to the mixed fund) including any increase in value.

What happens where the trust property is mixed with other innocent party's property into a static mixed fund?

The traditional rule is that where there is more than one innocent party whose funds have been misappropriated and mixed into the fund together, the innocent parties share 'pari passu' (equally) to their proportional interests. They are treated equally in matters of priority.

What happens where the trust property is mixed with other innocent party's property into an active fund?

In English equity, the traditional practice was to invoke **'*The Rule in Clayton's Case*' (1817), 35 ER 78' cb, p.1246** - a presumption in respect of bank accounts that the first money paid in is the first money taken out – unless that produces an inequitable result; *Barlow Clowes* v *Vaughan* [1992] 4 All ER 22.

In Canada and the United States, a different practice emerged. *Clayton's Case* and *Re Hallett* deal with presumptions based on identification of particular transactions with particular parties, which may yield undesirable consequences. In **Re Ontario (Securities Commission) and Greymac Credit Corporation (1986) 30 DLR (4th) 1 (Ont CA) , appeal dismissed [1988] 2 S.C.R. 172**, it was held that the rule in *Clayton's Case* need not apply to determine the competing claims of innocent beneficiaries in a mixed fund. The Court of Appeal held that it was preferable for the beneficiaries to share pro rata in the funds. Thus, the rule in *Clayton's Case* should be limited to the relationship between a bank and its customers and not be extended to the relationship between two innocent beneficiaries. **'The Lowest Intermediate Balance Rule' seeks a fairer method between competing innocents; as described in the case below, the**

rule states that ‘a claimant to a mixed fund cannot assert a proprietary interest in that fund in excess of the smallest balance in the fund during the interval between the original contribution and the time when a claim with respect to that contribution is being made against the fund.’

Law Society of Upper Canada v. Toronto-Dominion Bank
(1998), 42 O.R. (3d) 257 (C.A.)

A lawyer misappropriated trust funds from clients. The lawyer deposited money the day after the last misappropriation of money. The issue was who should have a superior claim to the money in the account – the person with the equitable interest in the last deposit, or, should all innocents be treated equally?

Per Blair JA:

> Overview
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> **9** The Bank's attempt to invoke the lowest intermediate balance rule in the circumstances of this case amounts to nothing more, in my opinion, than an attempt to re-invoke the rule in Clayton's Case, which was rejected by this Court and by the Supreme Court of Canada in *Re Ontario Securities Commission and Greymac Credit Corporation*, supra. The effect of applying the "lowest intermediate balance rule" to the competing claims of the trust fund beneficiaries is to permit the Bank - the last contributor - to recover what for practical purposes is all of its deposit, exactly the result which would transpire upon the application of the rule in Clayton's Case. I do not think that result is called for in the circumstances of this case.
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> **31** In the end, there remain two general approaches which may be taken to the resolution of how pro rata distributions are to be made in circumstances such as this case -- the rule in Clayton's Case having now been discarded for such purposes. The first is that of applying the lowest intermediate balance rule. The second is that of applying what Woolf L.J. called the pari passu ex post facto" approach, in Barlow Clowes International. There seems to be no binding authority compelling the application of one approach or the other to circumstances such as those in this case. The Court should therefore seek to apply the method which is the more just, convenient and equitable in the circumstances.
> **32** No authority has ever applied the lowest intermediate balance rule in circumstances involving the rival claims of trust beneficiaries, as I have already noted. The mechanics of how the lowest intermediate balance rule actually works have never been fully explained. Indeed, even in situations concerning defaulting trustees and beneficiaries, where the rule has been invoked, it does not appear to have been implemented in any case involving more than a small number of competing beneficiaries and a correspondingly small number of transactions. This, I suspect, is because although LIBR may be "manifestly fairer" in the pure sense of a tracing analysis, it is manifestly more complicated and more difficult to apply than other solutions.

33 What LIBR involves - as best I can ascertain it from the authorities and the literature bearing on the subject - is a transaction by transaction examination of the mixed fund, in terms of deposits made by the beneficiaries and withdrawals taken by the wrongdoer, and the application of a proportionality formula in respect of each such transaction. This approach has not found favour in cases where the problem has been faced, and acknowledged, directly: see, for example, Barlow Clowes International; and Windsor v. Bajaj (1990), 1 O.R. (3d) 714 (Gen Div).

The Governing Principle

34 In my view, the method which should generally be followed in cases of pro rata sharing as between beneficiaries is not the LIBR approach but the pari passu ex post facto approach, which has the advantage of relative simplicity. This approach involves taking the claim or contribution of the individual beneficiary to the mixed fund as a percentage of the total contributions of all those with claims against the fund at the time of distribution, and multiplying that factor against the total assets available for distribution, in order to determine the claimant's pro rata share of those remaining funds.

35 This solution is the type of resolution which has been adopted, on a practical basis, in most cases involving more than two or three competing beneficiaries. It is the solution applied by this Court in Greymac, and by the English Court of Appeal in Barlow Clowes International. It is the solution applied in a number of other recent decisions at the superior court level in this Province involving mixed trust funds, and it is the solution applied by Farley J. in the case under appeal. But it is not LIBR.

36 It is, however, the approach which I favour.

…

51 The significant problem with LIBR is that its application, in a form true to its tracing origins and rationale, is too complicated. It may be "manifestly fairer" than the rule in Clayton's Case in the sense that it attributes debits from the account equally and proportionately amongst the contributors. "Fairness" may be relative, however. Is the rule necessarily "fairer" when it limits contributors to the lowest intermediate balance in the account between the times of contribution and distribution? The rule in Clayton's Case works "unfairly" against the first contributors to the fund, because it attributes the first wrongful withdrawals to those contributions, eliminating some claims but allowing others to be compensated in full. The application of LIBR can have a similar effect, as the circumstances of this case indicate, because its "last in, first out" regime favours later contributors. At the same time, a pro rata sharing based simply on the claimants' contributions measured proportionately to the assets available for distribution can work against late depositors, as the circumstances of this case also illustrate.

52 What is at play here, in reality, is a choice of fictions. The rule in Clayton's Case and LIBR are both fictions. Any other rationale which

endeavours to establish a rule or principle on which equity will divide a shortfall amongst those entitled to claim against it is a fiction. Farley J. recognized the role of fictions, or "artificial rules" when he said, in his second Reasons, at pp. 6-7:

I do not see it as fair, equitable or practicable in the circumstances (and more especially since the Bank effected an inappropriate and unauthorized self help remedy to the detriment of the other claimants) to invoke LIBR. It seems to me somewhat artificial (recognizing that all the rules involved in this area are artificial rules which must be applied with caution so as to maintain the closest approximation of fairness, equity and reasonability, while recognizing practicality) to invoke libr which by its very nature "rewards" those innocents who are later on the scene as compared with those innocents who have been taken advantage of earlier when it is fairly clear that the wrongdoer would continue to fleece all the innocents if given the chance. Recovery should not be so dependent on a fortuitous accident of timing.

53 I agree. Earlier in these reasons I alluded to this Court's rejection, in Greymac, of the rule in Clayton's Case as "unfair and arbitrary" and "based on a fiction". In this latter regard, Morden J.A. cited (supra, at p. 686) the following oft-quoted passage from the decision of Learned Hand J. in Re Walter J. Schmidt & Co. (1923), 298 Fed. 314, at p. 316:

The rule in Clayton's Case is to allocate the payments upon an account. Some rule had to be adopted, and though any presumption of intent was a fiction, priority in time was the most natural basis of allocation. It has no relevancy whatever to a case like this. Here two people are jointly interested in a fund held for them by a common trustee. There is no reason in law or justice why his depredations upon the fund should not be borne equally between them. To throw all the loss upon one, through the mere chance of his being earlier in time, is irrational and arbitrary, and is equally a fiction as the rule in Clayton's Case, supra. When the law adopts a fiction, it is, or at least it should be, for some purpose of justice. To adopt it here is to apportion a common misfortune through a test which has no relation whatever to the justice of the case ... Such a result, I submit with the utmost respect, can only come from a mechanical adherence to a rule which has no intelligible relation to the situation.

54 Such is the case here, in my view. To apply the LIBR principle in the circumstances of this case would be "to throw all the loss upon [some], through the mere chance of [their] being earlier in time". It would be "irrational and arbitrary". It would be "to apportion a common misfortune through a test which has no relation whatever to the justice of the case". I do not favour it.

Easy Loan Corporation v Wiseman
2017 ABCA 58 (Alta. C.A.)

The defendant operated a Ponzi scheme. After the fraud was discovered, a receiver was appointed over the funds in the defendant's bank account. The receiver sought directions respecting apportionment between investors and defrauded investors.

The Court:

> **[The Chambers Decision Under Appeal]**
>
> [10] Next, the chambers judge determined the method to distribute the Frozen Funds. He considered three possible tracing schemes. He quickly rejected the first (the rule in Clayton's Case) and no complaint arises in that regard.
>
> [11] Easy Loan and the receiver contended the Frozen Funds should benefit all those wronged by the unlawful scheme in proportion to their investment with set-off for amounts already recouped, whereas the respondents said method three (see below) should apply.
>
> [12] The chambers judge explained the second two methods at para 55:
> (2) Pro rata or pro rata ex post facto sharing based on the original contribution that the various claimants made, regardless of the time they made their contributions. If there is a shortfall, between the amount the claimant's claim and the amount remaining in the account, the claimants share proportionately, based on the amount of their original contribution;
>
> (3) Pro rata sharing based on tracing or the lowest intermediate balance rule ("LIBR") which says that a claimant cannot claim an amount in excess of the lowest balance in a fund subsequent to their investment but before the next claimant makes its investment.
>
> [13] The chambers judge held that the third method was the "general rule", if workable. He held that "calculating entitlement to the Bank Account might be considered by some to be inconvenient and moderately complex. It is not, however, impossible to do the calculations. Inconvenience should not stand in the way of fairness": para 71. The chambers judge concluded set-off was not appropriate.
>
> [14] One of the respondent's lawyers calculated each claimant's entitlement. The entitlements ranged from $480,832.89 (paid to the investor who deposited $500,000, the final deposit in September the day before the account was frozen) to $46.20 paid to an investor who made his deposit of $100,000 three months earlier, in June. As is apparent, the distribution method chosen does not reflect a simple proportional approach: the late September investor recovered significantly more (proportionately) than the June investor. Because all of Easy Loan's investments were made prior to June, 2015, it received $309.95 of the $5.7 million it had invested.

[15] The Order also includes a distribution to Base Finance because it contributed to the Frozen Funds. Those funds were paid into court pending further direction.

[16] The calculations were incorporated into the Order, which also included the following: "The Application by the Receiver for an Order directing that the [Frozen Funds] be vested in the Receiver is hereby denied:" para 2. We draw attention to this paragraph because it puts to rest the receiver's contention that its application had yet to be heard.

…

Tracing Rules and Principles

[28] Three methods are available to trace commingled trust assets on deposit in a bank account. They are: (i) the rule in Clayton's Case; (ii) the lowest intermediate balance rule, also referred to as "pro rata on the basis of tracing", the "North American method", "rolling charge method" or "LIBR" ("LIBR"); and (iii) the pro rata approach, also referred to as the "basic pro rata approach", "pro rata ex post facto" or "pari passu ex post facto" ("Proportionate Distribution").

[29] The following general equitable principles apply.

[30] First, "modern [tracing] rules ... have been ... altered, improved, and refined from time to time": ***Re Hallett's Estate*** **at 710 per Jessel MR. And, "equity's ... flexible remedies such as constructive trusts, ..., tracing ... must continue to be moulded to meet the requirements of fairness and justice in specific situations":** ***Canson Enterprises Ltd. v Boughton & Co.*****, 1991 CanLII 52 (SCC), [1991] 3 SCR 534, 85 DLR (4th) 129 at 538. The significance of this principle will be apparent shortly, in the context of the applicability of the rule in Clayton's Case.**

[31] Second, the overarching goal of equity is "to serve the ends of fairness and justice": ***Canson*** **at 586 per LaForest J. When tracing into a commingled bank account that contains only trust funds, fairness of distribution is paramount. Balanced against fairness is a more pragmatic consideration: practicality and workability. "A rule that is in accord with abstract justice but which, for one or more reasons, is not capable of practical application, may not, when larger considerations of judicial administration are taken into account, be a suitable rule to adopt":** ***Ontario (Securities Commission) v Greymac Credit Corp*** **(1986), 55 OR (2d) 673, 17 OAC 88 at para 48, affirmed 1988 CanLII 5760 (SCC), [1988] 2 SCR 172.**

The Rule in Clayton's Case

[32] The Rule in Clayton's Case, also known as the "first in, first out" rule deems that funds deposited first into a commingled account are also the first funds withdrawn. The rule has been called "unfair, arbitrary, and based on a fiction": *Boughner* at para 81; see also *Greymac*.

[33] In *Alberta, Re Elliott (Legal Profession Act)*, 2002 ABQB 1122 (CanLII), 333 AR 39 rejected the rule in Clayton's Case. Case law from this court states that the rule in Clayton's Case is the "general" rule: *Sawchuk v Bourne*, 2005 ABCA 382 (CanLII), 144 ACWS (3d) 12; *Kretschmer v Terrigno*, 2012 ABCA 345 (CanLII), 539 AR 212 at para 93 per Slatter JA in dissent but not on that point.

[34] However, given the equitable tracing principles set out above and the parties' agreement that the rule in Clayton's Case did not apply in the present circumstances, we proceed on the basis that the rule in Clayton's Case has no application here. This leaves two other distribution methods.

Proportionate Distribution

[35] Proportionate Distribution divides the final balance in the commingled account in proportion to each claimant's original contribution to the fund. In other words, contributors share the shortfall in the account. An open question is whether set-off should apply against an investor's contribution as a result of funds the investor received from a return on capital, dividends, bonuses, etc. Given our conclusion that this is not the tracing method to use in these circumstances, there is no need to address set-off.

[36] Intermediate balances (see below) are not taken into account. See generally, Christian Chamorro-Courtland, "Demystifying the Lowest Intermediate Balance Rule: The Legal Principles Governing the Distribution of Funds to Beneficiaries of a Commingled Trust Account for Which a Shortfall Exists", 30 BFLR 39 (Nov 2014) at 42.

LIBR

[37] LIBR considers each beneficiary's contribution to the commingled account and the lowest balance in the account after each beneficiary's contribution. Simply put each beneficiary loses the ability to trace (and therefore claim) its contribution once the funds in the account drop below the amount of the beneficiary's contribution (deposit).

[38] A simple example: if X deposits $100 to a commingled account and the balance in the account later drops to $5, the most X can claim is $5, the lowest balance in the account; the ability to trace to anything more than $5 is lost because anything more comes from a funding source other than X. "Intermediate" refers to the period between X's contribution and when X makes the claim against the account. Once the lowest intermediate balance is determined for each beneficiary, each beneficiary is entitled to claim only the lowest balance's proportional share of the final balance of the account.

[39] *Law Society of Upper Canada v Toronto-Dominion Bank* (1998), 1998 CanLII 4774 (ON CA), 42 OR (3d) 257, 116 OAC 24 ("LSUC") at para 14 explains:

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

[40] It is self-evident that calculating the lowest balance in the account for each beneficiary's contribution is not workable or practical if the commingled account has many contributors, supporting records are unavailable or incomplete or the timeframe in question is lengthy. These problems do not arise in this case.

[41] Indeed, the proof is in the pudding. Counsel for one of the respondents calculated the lowest intermediate balance for each beneficiary and the proportion that each balance comprised of the Frozen Funds, all to the satisfaction of the chambers judge who personally signed the Order. No respondent disputes the amount.

…

[67] The chambers justice applied LIBR. The cases say this is the fairest rule absent two exceptions (unworkability or the contrary intention of the beneficiaries) which we have concluded do not apply.

[68] We leave the question of whether set-off should apply in the context of a Ponzi scheme for another time. The issue in this appeal is narrow given the imposition of the constructive trust which, as noted, is not appealed. However, had all the assets of Base Mortgage formed part of the traceable pool of assets, set-off may have been an appropriate consideration.