<u>Trusts & Equity</u>
Fall Term 2022

Lecture Notes – No. 14

<u>THIRD PARTY LIABLITY</u>

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.

(a) Knowing Receipt: 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.

...

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".

...

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.)*

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.**

(b) Third Party Accessories: Knowing Assistance

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:
>
>> 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.
>
> 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.

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.'
>
> \- *Pennell v. Defell* (1853), 4 DeG, M & G 372, 388 (Ch) per Turner LJ

'Following' in Law

B.M.P. Global Distribution Inc. v. Bank of Nova Scotia
2009 SCC 15

Here the issue was whether a bank could recover money from another bank where a customer deposited a forged cheque. The remarks on tracing are of relevance.

Deschamps J.:

> **4.4 Right to Claim the Amounts in BMP's Account and to Trace Funds in the Related Accounts**
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> 75 **Tracing is an identification process. The common law rule is that the claimant must demonstrate that the assets being sought in the hands of the recipient are either the very assets in which the claimant asserts a proprietary right or a substitute for them.**
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> 76 In the instant case, RBC's funds were first transferred through the clearing system to BNS in its capacity as collecting bank — and thus as agent — for BMP. BNS then made the entry in BMP's account to reflect the receipt of the funds from RBC. Finally, BMP made withdrawals from its account by way of transfers or cheques for deposit in the related accounts and, in the case of the transactions involving the $300,000 cheque, back to its own account. What is at issue here is a non-specific fund.
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> 77 Under ordinary circumstances, an agent cannot be sued in the principal's stead. However, as stated by Lord Goff and Jones in *The Law of Restitution*, at p. 847, citing *British American Continental Bank v. British Bank for Foreign Trade* (1925), [1926] 1 K.B. 328 (Eng. C.A.),where the agent has paid the money over to his principal but has received it back again so that his position is as it was before he paid it over, he must make restitution. Save for the $100 added to the bank draft, there is no issue of identification of the money in BMP's account. The unchallenged evidence is that it comes from the funds received from RBC. BNS, as agent, received the funds from RBC and, after crediting them to its principal, BMP, received them back under the banking contract. Having received the funds back, BNS had to make restitution to RBC. Therefore, BNS has a valid defence against BMP (see: *Bavins, Junr. & Sims v. London & Southwestern Bank Ltd.* (1899), [1900] 1 Q.B. 270 (Eng. C.A.)). BNS's status with respect to the funds in the related accounts is different. BNS

was not acting as agent of the holders of the related accounts. A review of the rules on tracing will therefore be helpful.

78 It has been accepted that the English case of *Agip (Africa) Ltd. v. Jackson* (1990), [1992] 4 All E.R. 451 (Eng. C.A.) (aff'g (1989), [1992] 4 All E.R. 385 (Eng. Ch. Div.)), has been accepted as setting out rules with respect to tracing of money: *Citadel General Assurance Co. v. Lloyds Bank Canada*, [1997] 3 S.C.R. 805 (S.C.C.).

79 According to the Court of Appeal in *Agip*, **tracing at law is permitted where a person has received money rightfully claimed by the claimant. Liability is based on mere receipt, and the extent of liability will depend on the amount received** (*Agip* (C.A.), at pp. 463-64; *Agip* (Ch.), at p. 399; *Banque Belge pour l'Etranger v. Hambrouck*, [1921] 1 K.B. 321 (Eng. C.A.)). **It is sometimes said that funds cannot be traced to bank accounts at common law. This view overstates the rule and fails to take into account the fact that, as an evidentiary process, tracing is possible if identification is possible** (see: D. R. Klinck, "'Two Distincts, Division None': Tracing Money into (and out of) Mixed Accounts" (1988), 2 *B.F.L.R.* 147, at p. 148, and L. D. Smith, *The Law of Tracing* (1997), at pp. 183 ff.). Indeed, no statement that tracing is impossible can be found in the case that is most often cited in support of the theory that funds cannot be traced to bank accounts at common law. If Lord Ellenborough C.J.'s comment in *Taylor v. Plumer* (1815), 3 M. & S. 562, 105 E.R. 721 (Eng. K.B.), is read in its entirety, **it is clear that tracing is impossible only when the means of ascertainment fail:**

> **<u>It makes no difference in reason or law into what other form, different from the original, the change may have been made, whether it be into that of promissory notes for the security of the money</u> which was produced by the sale of the goods of the principal, as in *Scott v. Surman*, Willes, 400, or into other merchandize, as in *Whitecomb v. Jacob*, Salk. 160, for the product of or substitute for the original thing still follows the nature of the thing itself, as long as it can be ascertained to be such, and <u>the right only ceases when the means of ascertainment fail</u>, which is the case when the subject is turned into money, and mixed and confounded in a general mass of the same description. The difficulty which arises in such a case is a <u>difficulty of fact and not of law</u>, and the dictum that money has no ear-mark must be understood in the same way; i.e. as predicated only of an undivided and undistinguishable mass of current money.**
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> [Emphasis added; p. 726]

…

85 In my view… it is possible at common law to trace funds into bank accounts if it is possible to identify the funds… as between innocent contributors, contributions are followed first to amounts they have withdrawn. In the case at bar, since the withdrawals of all those who received funds far

> exceeded their contributions, RBC can trace its own contribution to the balances remaining in the accounts.
>
> 86 … the question to be asked is whether the money deposited in those accounts was "the product of, or substitute for, the original thing" (p. 335). In the instant case, the identification process is quite simple. I will not go back over the issue of the funds in BMP's account: there was no relevant movement of funds. Regarding the funds in the related accounts when BNS acted on BMP's instructions and transferred money to the accounts of 636651 B.C. Ltd., Backman (chequing and savings accounts) and Hashka, the transferred funds were clearly related to the forged cheque BNS had mistakenly credited to BMP's account. The moneys used for the transfers came from BMP's account. The link is made with the funds RBC had used to pay the forged cheque.

'Tracing' in Equity

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

- If the third party is a bona fide purchaser for value without notice of the trust, 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.

- If the third party is not a bona fide purchaser for value without notice of the trust and retains the property, 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'.

- 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), 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:
>
> > "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."
>
> 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...**
>
> 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.]

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.

[With respect to 'backwards tracing'. See *Brazil v Durant International Corp* below]

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.

PWhat 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
>
> **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.
>
> **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.

Boughner v. Greyhawk Equity Partners Limited Partnership (Millenium)
2012 ONSC 3185 (Ont. S.C.J.)

Morawetz J.:

1 The issue to be determined is how to distribute commingled funds to the victims of a fraudulent investment scheme called the "Greyhawk Fund" ("Greyhawk" or the "Fund"). Following the discovery of the fraud and the appointment of A. Farber & Partners Inc. as receiver (the "Receiver"), a significant shortfall was discovered. The Receiver wishes to distribute the remaining funds; however, there is disagreement amongst the investors regarding the appropriate method of distribution.

2 Jack Waldock and the Waldock Group (together, "Waldock"), argue that the remaining funds should be distributed *pro rata* based on original contributions to the fund. This method is referred to as the "*pro rata*" method or the "*pro rata ex post facto*" method.

3 Richard Gibson ("Gibson") argues that distributions should be made *pro rata* based on actual fund performance during the period while each investor was invested in the fund. The method proposed by Gibson is generally known as the Lowest Intermediate Balance Rule ("LIBR"). The Receiver refers to it as the "fund unit allocation" method. It has also been referred to in case-law and elsewhere as "*pro rata* on the basis of tracing," the "North American" method, and the "Rolling Charge" method. Under LIBR, an investor cannot claim an amount in excess of the lowest balance in a fund subsequent to their investment and attributable thereto.

4 An example fact pattern is illustrative in demonstrating the difference between the methods advocated by Waldock and Gibson: A invests $100 in a fund. The value of the fund then declines to $50. B invests $100, bringing the balance in the fund to $150. The value of the fund then declines to $120.

5 In this fact pattern, if LIBR were applied, A could not claim more than $50, because that is the lowest balance in the fund prior to B's investment. In other words, the initial decline in the value of the fund from $100 to $50 is borne entirely by A. When B contributes $100, her investment constitutes 2/3 of the $150 in the fund. As a result, when the fund declines to $120, 2/3 of the decline

is borne by B, while 1/3 is borne by A. Therefore, of the $120 remaining in the fund, A can claim $40 while B can claim $80.

6 If, on the other hand, the funds were distributed *pro rata* based on original contributions, as Waldock maintains should occur in the present case, both A and B would receive $60, since both invested an equal amount: $100.

7 Which method is applied in the present circumstances will have significant financial consequences for the parties. The Receiver has calculated that if the funds are distributed using the *pro rata* method, Waldock will receive $694,856, and Gibson will receive $216,196. If the funds are distributed using LIBR, Waldock will receive $139,130, and Gibson will receive $958,662. The dollar amounts referred to throughout this endorsement are based on calculations performed by the Receiver.

…

Law and Analysis

69 Both parties argue that *Greymac* suggests their position. I disagree. I have concluded that the reasoning in *Greymac* aligns with the position put forth by Gibson.

70 *Greymac* is the controlling authority and, given the submissions of Waldock, must be contrasted with the decision in *Law Society*.

71 In *Law Society*, the issue before the court was how to distribute the funds in the comingled account and whether the bank should be able to claim priority with a *pro rata* distribution based on tracing (the court in *Law Society* referred to this as LIBR).

72 The court in *Law Society* found against the bank and concluded that distribution on the basis of *pro rata ex post facto* was appropriate.

73 The result in *Law Society* is consistent with the result in *Greymac*. Morden J.A. acknowledged in *Greymac* that, in circumstances where *pro rata* on the basis of tracing (LIBR) is not practically possible, distributions should proceed on a *pro rata ex post facto* basis. The court in *Law Society*, at page 271, determined that it was not "practical" to undertake a tracing exercise in the circumstances of that case:

> There are over 100 claimants. There were misappropriations in the area of $900,000 in bits and pieces. It is not even clear that each deposit and debit can be looked at individually, on the state of the record... It is not at all clear on the evidence that this exercise can be done.

74 *Law Society* expressly rejected the rule in Clayton's Case. The court then considered *Greymac*, but arrived at the conclusion that it was not practical to apply *pro rata* tracing on the facts of *Law Society*. Blair J. (*ad hoc* at the time) found, in *Law Society*, at page 267: "In my view, however, this approach

is too complex and impractical to be accepted as a general rule for dealing with cases such as this".

75 Blair J. went on to state, at page 269: "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".

76 Given the statements in *Law Society*, and the fact that *Law Society* follows *Greymac*, it is necessary to consider the statements of Blair J. in *Law Society* in the context of the decision. In doing so, it seems to me that there is no direct contradiction between the two decisions.

77 At the outset of *Law Society*, Blair J. introduces the case: "It raises issues concerning what is known as "the rule in Clayton's Case" and a descendant concept called "the lowest intermediate balance rule" (frequently referred to by the acronym "LIBR")".

78 At part 2 of his decision, entitled "Law and Analysis", Blair J. references the following subheading: "A Consideration of 'The Rule in *Clayton's Case*' and the 'Lowest Intermediate Balance Rule'".

79 His overview of this section, at page 261, states:

> 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 reinvoke the rule in Clayton's Case, which was rejected by this court and by the Supreme Court of Canada in *Ontario (Securities Commission) v. Greymac Credit Corp.*, *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 deposits, 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.

80 At page 262, Blair J. went on to state:

> Speaking for a unanimous court in *Greymac Credit Corp.*, Morden J.A. resolved that as a general rule the mechanism of *pro rata* sharing on the basis of tracing was the preferable approach to be followed, although he left room for other possibilities such as those circumstances where it is not practically possible to determine what proportion the mixed funds bear to each other, or where the claimants have either expressly or by implication agreed among themselves to a distribution based otherwise than on a *pro rata* division following equitable tracing of contributions (pp. 685-90). Whatever approach was chosen, Morden J.A. was concerned that it should be one which met the test of convenience — or "workability", as he termed it (p. 688). The core of the court's conclusions is to be found in the following passage from its judgment at p. 685:

> The foregoing indicates to me that the fundamental question is not whether the rule in Clayton's Case can properly be used for tracing purposes, as well as for loss allocation, but, rather, whether the rule should have any application at all to the resolution of problems connected with competing beneficial entitlement to a mingled trust fund where there had been withdrawals from the fund. From the perspective of basic concepts, I do not think that it should. The better approach is that which recognizes the continuation, on a *pro rata* basis, of the respective property interests in the total amount of trust monies over property available.

Having determined that the rule in Clayton's Case ought not to be applied in cases involving the claims of competing trust beneficiaries, Morden J.A. concluded in *Greymac Credit Corp.* that *pro rata* sharing based on the respective property interests of the claimants and the total amount of trust money or property available, should be applied. He accepted such *pro rata* sharing as the general method of determining such competing interests. Whether, as some have suggested, he also recognized and incorporated into the *pro rata* sharing exercise the concept of the lowest intermediate balance rule, and if so to what extent, is an issue that will be dealt with momentarily. First, however, I propose to turn to an analysis of the history and application of the LIBR notion.

81 From the above, I discern the following:

(i) The controlling authority, *Greymac*, clearly rejects the rule in Clayton's Case as unfair, arbitrary, and based on a fiction.

(ii) The court in *Greymac* held that, as a general rule, the mechanism of *pro rata* sharing based upon tracing (or LIBR) was the preferable approach to resolving competing claims to mingled trust funds.

(iii) In *Law Society*, the outcome is consistent with *Greymac*. At page 271, Blair J. states:

> **In this case, it is not practicable to conduct the LIBR exercise. There are over 100 claimants. There were misappropriations in the area of $900,000 in bits and pieces. It is not even clear that each deposit and debt can be looked at individually, on the state of the record, although the total amounts deposited by each of the claimants are apparently known. Notwithstanding this, if the LIBR principle is to be applied to a pro rata distribution in the circumstances of this case, it would be necessary to consider not only the deposits of each individual claimant and the timing of such deposits, but also what was the lowest balance in the Upshall account between each deposit and the imposition of the freeze. This would involve analyzing the pattern and timing of each misappropriation and applying the results to each individual deposit or circumstances. It is not at all clear, on the evidence, that this exercise can be done.**

(iv) The finding in *Law Society* as expressed above falls within the exception provided for in *Greymac*. In essence, the general rule as stated by Morden J.A., could not, in the view of Blair J., be applied in the circumstances of *Law Society*. The court in *Law Society* spent considerable time addressing the parameters and practical application of LIBR. However, this analysis has to be considered in the context of the conclusion reached by Blair J. as set out at page 271, namely, "In this case, it is not practicable to conduct the LIBR exercise".

82 There is no doubt that the issues, terms and concepts discussed at length in both *Greymac Credit Corp. Credit Corp.* and *Law Society* are complex. As noted by Blair J., at page 267, in reference to the British Columbia Law Reform Commission in its "Report on Competing Rights to Mingled Property: Tracing and the Rules in *Clayton's Case*" (1983), terms like "*pari passu*", "*pro rata*", "rateably", and "proportionally" are inherently ambiguous. To this list of terms can be added, "LIBR", the "rolling charge", and the "North American" approach. It seems to me that these terms have not always been used with precision and, as a result, considerable confusion has arisen in the cases.

83 A further example of the issue is set out in *Graphicshoppe*. Writing for the majority, Moldaver J.A. (as he then was) at para. 126 and following stated:

> 126. ...the reasoning in *Law Society* as it relates to the issue of how best to allocate the funds remaining in a mixed trust account between competing beneficiaries simply has no application to this preliminary question. The same thing can be said about the reasoning in *Greymac Credit Corp.*, which, like the reasoning in *Law Society*, focused on the resolution of beneficiaries' competing proprietary claims to the remaining trust funds.
>
> 127. I would also add that throughout his reasons for judgment in *Law Society*, Blair J. (*ad hoc* at that time) clearly acknowledged that the issue before the court was confined to determining the best approach for resolving the claims of competing beneficiaries to funds remaining in a mixed trust account. Blair J. considered the *pari passu ex post facto* approach to be the best approach for that task because of the inconvenience that is often associated with having to apply the lowest intermediate balance rule [or *pro rata* on the basis of tracing] in cases involving any significant number of beneficiaries in transactions, and because of the nature and purpose of the mixed trust fund. In Blair J.'s view, such a fund is in many ways a mechanism of convenience, in that it avoids the necessity, cost and cumbersome administrative aspects of having to set up individual trust accounts for each beneficiary. Blair J. reasoned that "a mixed fund of this nature should be considered as a whole fund, at any given point in time, and that the particular moment when a particular beneficiary's contribution was made and the particular moment when the defalcation occurred, should make no difference".

84 This passage from *Graphicshoppe* confirms that in *Law Society* Blair J. determined the *pro rata ex post facto* approach to be the best approach in that case because of the inconvenience that is often associated with having to apply LIBR in cases involving any significant number of beneficiaries and transactions, and because of the nature and purpose of the mixed trust fund. In my view, neither *Law Society* nor *Graphicshoppe* stand for the proposition that LIBR is not to be utilized when circumstances are such that it can be. Rather, consistent with *Greymac*, the general rule is that LIBR should be applied unless it is unworkable. As Morden J.A. stated in *Greymac*, at page 688: "I am not persuaded that considerations of possible inconvenience or unworkability should stand in the way of the acceptance, as a general rule, of *pro rata* sharing on the basis of tracing [or LIBR]".

85 In *Graphicshoppe*, the decision involved trust claims of employees to a mixed fund. In dissent, Juriansz J.A. followed the analysis of Blair J. in Law Society and expressly rejected "the logic of the LIBR".

86 However, Moldaver J.A., writing for the majority, did not agree with Juriansz J.A.'s "analysis or conclusions". In arriving at his decision, Moldaver J.A. applied LIBR: "...it is clear from the record that as of the date of bankruptcy, none of the employee contributions that had been deposited into *Graphicshoppe*'s bank account remained intact. We know that with certainty because prior to the date of bankruptcy, the account went into negative balance".

87 Justice Moldaver distinguished *Law Society* on its facts and also addressed the role of LIBR. After citing Lionel Smith's article, Moldaver J.A. stated:

> I recognize that my colleague Juriansz J.A. says that this argument is simply an attempt to apply the logic of the lowest intermediate balance rule. With respect, assuming that characterization is correct, I do not see how applying this logic can be erroneous, when in this case, it is solidly supported by the facts.

88 Thus, it seems to me that although the Court of Appeal for Ontario did not, on the facts, apply LIBR in *Law Society*, it was accepted by Moldaver J.A. in *Graphicshoppe*. Thus, by virtue of the Supreme Court of Canada's affirmation of *Greymac* and the more recent decision in *Graphicshoppe*, LIBR is an available mechanism to distribute comingled funds.

89 The controlling authority, *Greymac*, directs, in my view, that *pro rata* sharing based on tracing (LIBR) is the "general rule" that ought to be applied in this case unless it is practically impossible to do so.

90 In the present case, I accept the uncontroverted evidence of the Receiver that all steps have been taken to establish that LIBR calculations can be made. As such, the general rule as set out in *Greymac* must be applied in this case.

91 In my view, the application of the general rule as set out in *Greymac* produces a result that I consider to be just and equitable. Morden J.A. recognized that the principles of "logic, justice and convenience" govern in circumstances such as these (see *Greymac* at page 680). Blair J. in *Law Society* also noted that "the court should therefore seek to apply the method which is the more just, convenient and equitable in the circumstances" (see *Law Society* at page 269).

92 On the facts of this case, justice dictates that the funds should be distributed proportionately based on the interests of the parties at the time of comingling: the Receiver's fund unit allocation method (or LIBR). A *pro rata ex post facto* distribution would not result in a fair outcome where a very small number of individuals, including Waldock, had invested a significant amount of money early on in the lifespan of the fund. By the time of Gibson's investment, the evidence is clear that these early investors had lost over 88% of their investment value.

93 In this case, the practical concerns cited in *Greymac* do not exist. The Receiver has determined a practicable method for distributing the Greyhawk Fund *pro rata* on the basis of LIBR. The Receiver has confirmed that it had the necessary information to complete its calculation accurately.

94 Waldock raises the issue, at paragraph 9 of the Reply Factum, that the evidence of the Receiver is that it would be impossible to trace the various investments and transactions that occurred in this case. The Receiver has determined that it cannot trace or match trades and securities to specific investors as investor funds were comingled over a lengthy period. To further complicate matters, the Receiver has confirmed that it is not possible to match any particular sale of securities to a corresponding redemption. However, there is no evidence to suggest that the Receiver would need to be able to do these things in order to properly calculate distributions using the fund unit allocation method (LIBR). Rather, as noted previously at [36], the evidence of the Receiver is that it has been able to make these calculations in spite of the challenges noted by Waldock.

Disposition

95 For the foregoing reasons, I direct that distributions be made pursuant to the fund unit allocation method (or *pro rata on the basis of tracing*, or LIBR).

96 In recognition of the fact that this issue had to be determined prior to any distribution and given that both Waldock and Gibson were victims of a fraud, it is appropriate that the costs of the parties be paid out of the assets of the Greyhawk Fund.

Brazil v Durant International Corp
[2016] A.C. 297 (PC (Jer))

This case involved tracing large proceeds of bribery through a complex web of bank accounts.

Lord Toulson:

> 1. This appeal concerns the doctrine of tracing. The effective plaintiff is the Municipality of Sao Paulo ("the municipality"). The Federal Republic of Brazil is nominally a plaintiff because its Constitution requires it to be a party to any action brought outside Brazil by a Brazilian public authority. The defendants ("Durant" and "Kildare") are companies registered in the British Virgin Islands. Kildare is a wholly owned subsidiary of Durant and both companies are or were at the relevant time under the practical control of Mr Paulo Maluf and/or his son Mr Flavio Maluf. From 1993 to 1996 Mr Maluf senior was mayor of the municipality.
>
> …
>
> 11. The other limb of the appellants' argument is that the Chanani account was a mixed account; and that where a claimant's money is mixed with other money, and drawings are made on the account which reduce the balance at any time to less than the amount which can be said to represent the claimant's money, the amount which the claimant can thereafter recover is limited to the maximum that can be regarded as representing his money ("the lowest intermediate balance rule"). In this case it is said that on two occasions (20 and 23 January 1998) payments were made from the Chanani account to the Durant account of sums which exceeded the maximum that could be said to have come from the earlier bribes itemised in schedule 3 and must therefore have come from other sources.
>
> 12. The parties agreed at the trial, as a matter of arithmetic, that if either limb of the argument was correct, the effect would be to limit the traceable amount to the same figure of US$7.7m.
>
> …
>
> 17. The appellants' twin arguments have a common and simple logical parentage. The doctrine of tracing involves rules by which to determine whether one form of property interest is properly to be regarded as substituted for another. It is therefore necessary to begin with the original property interest and study what has become of it. If it has ceased to exist, it cannot metamorphose into a later property interest. Ex nihilo nihil fit: nothing comes from nothing. If the money in a bank account has dwindled from £1,000 to £1, only the remaining £1 is capable of being substituted by something else; the £999 has ceased to exist. This explains "the lowest intermediate balance" principle. Similarly, a property interest cannot turn into (or provide a substitute for) something which the holder already has; the later acquisition cannot be the source of the earlier. This explains the "no backward tracing" principle. The two are in a sense opposite sides of the same coin.

…

28. The appellants' argument has academic support, most fully developed in Professor Matthew Conaglen's article "Difficulties with tracing backwards" (2011) 127 LQR 432, written in riposte to the argument of Professor Smith (to which Sir Richard Scott V-C referred in *Foskett v McKeown*).

29. Professor Conaglen begins with the proposition that "Tracing is the process of identifying a new asset as the substitute for the old" (per Lord Millett in *Foskett v McKeown* at [2001] 1 AC 102, 127). He observes that the acquisition of an asset and the extinguishment of a debt are different things. A debt is an asset in the hands of the creditor, and so can provide a basis for traditional tracing in relation to the creditor's assets. But a debt has no asset value in the hands of the debtor; it is a liability which ceases to exist when it is paid.

30. Having said that, Professor Conaglen accepts that there is nothing conceptually impossible about the courts tracing trust funds through the payment of a debt into assets that the trustee had acquired, before that payment was made, by incurring the debt. But he argues that the support in the case law for such an approach is weak and that there is stronger authority against it.

31. Professor Conaglen recognises that it is ultimately a matter of legal policy whether the law ought to allow backward tracing. He concludes, at p 455:

> "When the already precarious position of unsecured creditors is weighed against the concomitantly far better protected position of trust beneficiaries, it is suggested that the law ought not to recognise the possibility of tracing backwards. The unsecured creditors should not have their position worsened further by effectively making them insurers for the beneficiaries against trustee defalcations. Trust beneficiaries whose money has been wrongly applied in satisfaction of a debt can stand in the position of the satisfied creditor (by subrogation), but it is a step too far, in policy terms, to allow them to stand in the position of the debtor and act as owners of property that the trustee acquired before the debt was paid.
>
> Alternatively, if backward tracing is to be allowed, then the policy concerns that have been highlighted above suggest that the extent to which payment of the debt is considered attributable to acquisition of the asset should perhaps be limited in some way, such as by reference to whether the trustee intended at the time the asset was acquired to (mis)use trust funds to pay for it. … That would be consistent with equity's traditional concern for substance – meaning intention – over form. However, the evidential difficulties inherent in a test that is focused on the defalcating trustee's intentions provide yet further reasoning for concluding that the balance is appropriately struck by refusing to recognise backward tracing."

32. The respondents found their arguments on the passage already quoted from in Lord Millett's speech in *Foskett v McKeown*. They emphasise that it is inaccurate to speak of tracing one asset into another. Rather, the court is concerned with tracing the value inherent in a trust asset. Whether it can properly be traced into another asset depends on whether there is a sufficient transactional link. In considering that question the court should concentrate on the substance of the transaction and not the form. In general terms those propositions carry force, but they do not resolve the disputed issues.

33. More particularly the respondents submit, as Professor Smith argues, that money used to pay a debt can in principle be traced into whatever was acquired in return for the debt. That is a very broad proposition and it would take the doctrine of tracing far beyond its limits in the case law to date. As a statement of general application, the Board would reject it. The courts should be very cautious before expanding equitable proprietary remedies in a way which may have an adverse effect on other innocent parties. If a trustee on the verge of bankruptcy uses trust funds to pay off an unsecured creditor to whom he is personally indebted, in the absence of special circumstances it is hard to see why the beneficiaries' claim should take precedence over those of the general body of unsecured creditors.

…

38**. The development of increasingly sophisticated and elaborate methods of money laundering, often involving a web of credits and debits between intermediaries, makes it particularly important that a court should not allow a camouflage of interconnected transactions to obscure its vision of their true overall purpose and effect. If the court is satisfied that the various steps are part of a coordinated scheme, it should not matter that, either as a deliberate part of the choreography or possibly because of the incidents of the banking system, a debit appears in the bank account of an intermediary before a reciprocal credit entry. The Board agrees with Sir Richard Scott V-C's observation in *Foskett v McKeown* that the availability of equitable remedies ought to depend on the substance of the transaction in question and not upon the strict order in which associated events occur.**

39. Similarly, in a case such as *Agricultural Credit Corpn of Saskatchewan v Pettyjohn*, the Board does not consider that it should matter whether the account used for the purpose of providing bridging finance was in credit or in overdraft at the time. An account may be used as a conduit for the transfer of funds, whether the account holder is operating the account in credit or within an overdraft facility.

40. The Board therefore rejects the argument that there can never be backward tracing, or that the court can never trace the value of an asset whose proceeds are paid into an overdrawn account. But the claimant has to establish a coordination between the depletion of the trust fund and the acquisition of the asset which is the subject of the tracing claim, looking at the whole transaction, such as to warrant the court attributing the value of the interest acquired to the misuse of the trust fund. This is

likely to depend on inference from the proved facts, particularly since in many cases the testimony of the trustee, if available, will be of little value.