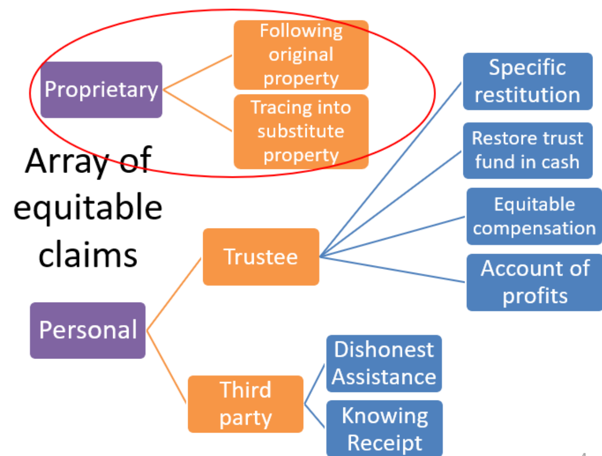
Equitable Tracing

Array of equitable claims



- Suppose X [trustee] takes valuable painting that forms part of the trust property and transfers it to Y (who takes it in knowledge of the trust), who in turn sells it to Z.
- Suppose also that X has no significant assets
  - (1) X is still liable personally to account to B (but this might not be worth much)
  - (2) Y's actions give rise to personal liability for *knowing receipt* of trust property
  - B will likely bring claims for (1) and (2), but may be *most interested* in tracing to the **proceeds** of the sale to Z (now in Y's hands).
- Make a proprietary claim against Z, but may not work if 1) bona fide purchaser i.e. have no notice of trust 2) for value
- Can then make a proprietary claim and trace for substitute property which the trust property was exchanged for

Tracing is a process where plaintiff traces what has happened to their property and identify the persons who have received it and justify their claim that the money received can be regarded as their property. Based on the retention of a beneficial interest of the property which they received. Applies to both proprietary or personal remedy against a knowing recipient. - *Boscawen v Bajwa* [1995] EWCA Civ 15

Following vs tracing

- <u>Following</u> simply means identifying where one's property has gone, and pointing to it in the hands of whoever has it; it focusses on the original property
- <u>Tracing</u> is still about property, but it looks to what a particular person has done with your property, as they substitute your original asset for various other rights in the course of their dealings
- A 'tracing process' will usually include both - *Foskett* page 127
- Equitable proprietary claims less secure than common law ones.
- In common law can make proprietary claim against anyone with the property
- In equity, claim runs out when someone has given value without knowledge of breach.
- Tracing: lost ability to receive property fallen into third party, instead claim for property exchanged for in the hands of the trustee

What is tracing?

- The claimant is identifying property that they never previously had any right in…. and saying that it is theirs
- The law allows the claimant to make their claim against <u>substitute</u> property
- The traced property represents the value / transactional proceeds of the original property, so belongs to the claimant; *Foskett* 128C

When is tracing useful?

- When a claimant's personal claims against trustee are not promising – eg trustee is insolvent eg *Foskett* 130C-E
- When the original trust property cannot be claimed, but 'substitute' property can be
- When the substitute property is more valuable than the original property
- As part of a personal or proprietary claim against a third party
- In practical terms, tracing is a part of many claims for proprietary relief

Tracing in equity

- Requirement of a pre-existing equitable interest or fiduciary relationship *Foskett* 128G
  - Historical roots of equity in a separate court of law
  - An initial equitable 'proprietary base'
  - Requirement of equitable base now doubted by commentators and in obiter comments, due to tracing being an evidential process, rather than a common law or equitable claim. In other words, should be able to use 'equitable' rules for common law claims

What can the claimant get?

- An Equitable ownership interest – 'constructive trust' over the traced asset, or over proportion of mixed fund
- An Equitable lien/charge (property right as security to protect payment of value to claimant; court will order for sale of the asset and payment of sum outstanding—enforcing repayment of misapplied property.)
- These are <u>proprietary</u> rights
  - Insolvency protection
  - Increases in value / secondary profits (CT)
- Will depend on initial equitable property right – *Foskett* 128D-F

Loss of the 'right to trace' in equity

- Traced property is destroyed, or can no longer be found
  - Eg money paid out of bank accounts and untraceable
- Traced property in hands of a bona fide purchaser for value without notice: 'equity's darling'.

Tracing in Equity (into Mixtures)

No mixture

- Just as with common law tracing, equitable tracing allows someone to make equitable proprietary claims to money in a bank account or assets purchased with money <u>that is exclusively derived from the original trust property</u>
- The beneficiaries will be able to adopt the new asset as though it was an authorised investment
- *Foskett* 130A
- As the beneficiary takes the whole asset, it generally does not matter if we think of this as a constructive trust or as a lien

Mixtures - Basic rules

- As between Bs and other innocent contributors = <u>proportionate shares</u> (neutrality)

- As between Wrongdoer and B: wrongdoer's rights are subordinated. We presume wrongdoer has acted as she should have OR B can identify her value in any place it could possibly be found
  - Eg Money 'drunk' at Foxglove was wrongdoer's
  - Money remaining is the B's – *Re Hallett's*
    - But plaintiff's claim cannot be more than lowest intermediate balance; overdrawn accounts have none of the plaintiff's money in them, and money subsequently put in is not the plaintiffs (unless defendant intends to restore plaintiff's money).
  - Money spent on valuable property was B's: *Re Oatway*

Foskett v McKeown

- Trustee (Mr Murphy) takes money held on trust and uses it for his own purposes – including paying 2 out of 5 life insurance policy premium payments
- Murphy commits suicide, and insurance payment of $1m paid to children
- Murphy's breach of trust identified, and most original trust moneys were spent
- Beneficiaries of trust claim a proportionate share of life insurance payment (2/5), but children (and CA) say only premium amounts repayable

Q: What is the distinction, if any, between Mr Murphy's children [technically the trustees of the estate] and the innocent volunteers in situation 1. Aren't Mr Murphy's children innocent volunteers?

- Where there are innocent volunteers who contributed *their* property to the mixture: then the B and V hold proportionately without 'subordination'
- *Foskett v McKeown*: Children stand in the position of Mr Murphy; their rights to the fund are determined on the basis of the mixture of *errant trustee's* property and the wrongly used trust property
- So apply the rules applicable between errant T and B

<table>
<tr><td>Foskett v McKeown</td></tr>
<tr><td>Facts:
• Murphy deceased. Developing property in Portugal through deposits.
• He later does not do development. Investors later want money returned but not enough left.
• Murphy used 20,000 of investor's money to pay premium for a life insurance policy
• Investor: proprietary right to a proportionate claim of insurance payments as they had paid for a % of them
• Proprietary right enables investors to trace for what was done with the property – money moved from depositor to Murphy's bank account which has subsequently increased following an exchange of value with the rights under the insurance contract. Claim is for the assets substituted for the original trust property.
• Proprietary right stops with insurance company as it is a bona fide purchaser of value without notice.
• Mixture of beneficiary and trustee's property exchanged for rights under the insurance contract.
• Murphy settled insurance contract on trust for children but Court: does not matter as children cannot stand in a better position than Murphy was
• Children's trust: recognise investor's proprietary right but value limited to the property which the beneficiary could make from the real estate development</td></tr>
</table>

• Investors could assert a liens where if do not pay back a certain amount then have a claim over certain property to the value of the loan. Smaller than claiming for the increased value from the insurance pay-out – can only claim for the amount put in or security interest.

Result:
• Court: investors could also claim under a constructive trust whereby the investors owned the asset. Not asserting a security interest, instead asserting an ownership claim over assets i.e. certain rights under the insurance contract.
• Due to mixture between beneficiary and trustee money, investors claiming a proportionate share of value from the rights under insurance contract. Not limited to asserting a liens and only getting back what was invested.
• Court: not a good argument that the trustees can confine the beneficiary to a liens if property has increased in value i.e. return only the premiums.
• Beneficiary can choose whether to claim for a proprietary right against substitute asset as a:
  o Security interest
  o Ownership proprietary interest – constructive trust over a proportionate share of substitute asset. Not attractive if substitute asset decreases in value.
• Mixed property between trustee and multiple beneficiaries:
  o If increase in value, apply shared ownership over constructive trust between the beneficiaries who have a proportionate share according to contributions
  o If decrease in value, between innocent beneficiaries or third party's property, cannot assert a liens against each other. Can only claim for proportionate ownership depending on contribution

What, in Lord Millett's view, was wrong with Hobhouse LJ's approach in the Court of Appeal?

- The CA said the final payments were not causally responsible for the payout
  - that was wrong: all of the money paid to the insurance co was part of a mixed fund that paid off the units; we look at the transaction where the rights are exchanged
- Beneficiaries could get the money back through a lien, but not a share of the profits.
  - In Lord Millett's view, this proved too much: if there is a proprietary claim, it should be a CT

T mixes T's money and B's money in purchasing another asset

- B is entitled at B's option to a *proportionate share* in the new asset *or* a *lien* over the asset to secure the full extent of his personal claim against T (*Foskett v McKeown* 131)
- What to take? Proportionate share if rise in value; lien if fall in value

T (errant trustee) mixes T's property with B's property in a mixed fund

- *T*'s claims are subordinated to B's claims (*Foskett v McKeown*; p 132)
- Property left in fund is B's (*Re Hallet's Estate*)…
- T is assumed to spend T's own money first
- unless *Re Oatway* applies: B can claim their money was used for valuable investments
- *Foskett*: beneficiary choice (CT or lien) 131F-H

Trustee mixes funds from two beneficiaries

- Proportionate share in the fund (constructive trust)
- If beneficiaries' funds put into trustee's account, then "subordinating" rules above apply to Trustee's share
- English exception for current bank accounts in *Clayton's case*: first money in is the first money out
    - Money paid into account earliest is spent on asset acquired earliest
    - Can lead to 'unfair' results, and is increasingly avoided and criticized
- Rule in Clayton's case (later rejected): if there is money in and out of bank accounts, and need to determine which credit was used to pay which debit, first in is the first out
- Courts will not apply this in contest between beneficiary and trustee
- Re Hallet's Estate: beneficiary can choose and is allowed to identify their property wherever it possibly could be
- Foskett – asset bought with mix of trustee and beneficiary property, courts help beneficiaries and give them the best possible proprietary claim

"lowest intermediate balance rule"

- Once the trust funds in a mixed account have been spent, equity cannot trace B's rights into funds *subsequently* deposited
- B's money has been paid out
- the same applies when only some of the money has been spent
- Subsequent deposits are T's: cannot be B's
- Lowest intermediate balance rule – the beneficiary can only trace and identify their property anywhere it possible could be. If during intermediate time between beneficiary's money put into the account and the claim, if the balance goes below the amount of the claim then the beneficiary can only claim for the lowest intermediate balance.
- Focus on when investors put money in and any payments out at any point of time which must be at a proportionate share.
- Re Hallet allows beneficiary to choose whether money left in bank account or claim on asset purchased was theirs, but depends on the beneficiary to say it was logically possible that their property was in the account.
- Balance of account cannot go below amount claiming, otherwise beneficiary's money was spent and someone else's money was put into bank account.
- Makes sense that later investors should not bear earlier losses when it cannot have been her funds.
- Difficult to apply when have 100s hundreds of contributors. Have to constantly update their proportional ownership according to the amount of money going in and out.
- Often too difficult eg. Yuan Fu where accounting records not good and too costly to apply lower intermediate balance approach.
- Liquidators often share the left-over amounts pro rata or on a pare passu basis by determining the proportion each investor has put in.

property is destroyed, or V (or errant Trustee) dissipates the funds ("spent upon a dinner")

- tracing in equity is not possible.
    - "equity is as hopeless as the common law itself"
- Equitable tracing presupposes the existence of property: the "fund"
- Personal claims for the breach of trust are still possible – but are "unsecured"

- [*Re Goldcorp*]

T or V uses trust money to repay a debt. Ie bank overdraft, debt owed due to asset purchase on credit
The payment of the debt discharges an obligation… what property would B be claiming?
'Backwards tracing' into asset bought earlier that created the loan debt? Orthodox theory is that B's money did not pay for T's asset
But… PC recently stated that such claims should be allowed: "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." Brazil v Durant International [2015] UKPC 3

V innocently receives and uses trust property to *improve* V's property

- "The question whether tracing is possible and if so to what extent, and also the question whether an effective remedy by way of a declaration of a charge can be granted consistently with <u>an equitable treatment of the</u> innocent volunteer, present quite different problems ….." *Re Diplock* [1948] Ch 465

- Ponzi scheme where different beneficiary monies added
- Did not apply Re Hallet where beneficiaries can choose where their property was spent on as beneficiaries between themselves could not subjugate each other's rights

<table>
<tr><td>Finnigan v Yuan Fu</td></tr>
<tr><td>Facts:
• Investors had credit on online trading accounts after paying Yuan Fu certain amount. Yuan Fu purchases the shares for the investors held by a share broker, Satso Bank and Yuan Fu advised Satso Bank to open accounts for investors
• Investors can see the shares in their account, some worth more than what they had paid initially and individually identify trust property as shares
• Investors: why share trust property proportionately when trust property not held in a mixed fund. "As the investor has established their ownership of the shares, it should not matter that Yuan Fu is insolvent and has gone into liquidation."
• However, money contributed by investors were held in a mixed pool by Yuan Fu
• Liquidators: too difficult to apply lowest intermediate balance rule so apply pare passu or proportionate share. No-one can claim for a particular dollar in account.</td></tr>
<tr><td>Result:
• Applied pare passu. Not enough evidence to use lowest intermediate balance
• Satso Bank opened accounts of shares on credit, which were repaid by Yuan Fu from a mixed, general account. Pool of money from investors held by Yuan Fu not always used to purchase shares.
• Property did not shift from beneficiaries' account to the trust property held by the investors
• Yuan Fu notionally attributed rights to beneficiaries according to money invested despite owing rights to SB which did not make the beneficiaries an owner
• Yuan Fu should not be able to choose which investor held beneficial ownership of the accounts with SB when its business model pooled all of its funds into a mixed account</td></tr>
</table>

where one cannot identify what belonged to who, which was used to pay for entitlements at SB • Nothing has occurred which meant individual investors can claim the shares are held for them • Follows tracing logic where there is a mixture of beneficiary funds in a fungible mass in a single account.

Priest v Ross Asset Management Ltd
Facts: • Clear breach by trustee – Ponzi scheme where investors receive 10 million out of the 450 million invested. • Priest claims their funds were separate from those mixed in the account and hence, should not have to share proportionately. • Priest puts money into an account controlled by RAM which was supposed to be held on trust where it invested other investor's money as it chose to. • Priest wanted to invest in certain shares but cannot invest in them himself for tax reasons. He wanted his friend Ross to purchase them for him. • Ross purchased shares from MCL, the brokerage Priest worked for. Priest chose which shares to be purchased, gave money to Ram and held in an account in Priest's name • RAM was owner of the account and held it on trust for Priest who was beneficial owner. • Similar to Yuan Fu where money was mixed into one account from other investors and Priest used to purchased shares. No certainty of subject matter at the individual beneficiary level in Lehman. • Liquidators: Basic tracing rules when mixture of beneficiary property and does not belong to any particular beneficiary. Can apply the lowest intermediate balance, but if too expensive then apply proportionate sharing of money • Investors: pare passu or proportionate share applies as Priest's money went into a mixed account with other investors where the money became unidentifiable. The investors paid for Priest's property so cannot be held on trust for them – tracing rules mean what was purchased with trust property belong to the beneficiaries. The Priests have a proportionate share of their property used to purchase shares.
Result: • Court: mixture irrelevant as clear Priest's arrangement was separate from the Ponzi scheme. • Priest different as he was never part of the Ponzi scheme. Priest chose the shares. RAM did not invest for Priest, and was only the notional owner of the shares purchased on Priest's behalf. • Shares purchased from brokerage were always held on express trust for Priest when RAM became owner. • If Priests paid money to RAM to pay to MCL and RAM held ownership, then there was no mixture. • Re Registered Securities – possible for person providing funds into a mixed account to claim that it belonged to them. On the facts of that case, it was not possible for the equivalent of Priest claiming a beneficial interest to identify their money to have been spent on asset held on trust as overdraft which meant the money had disappeared, so asset was paid for with nothing

- In this case the account was not overdrawn which means Priest's property can be identified from money coming in which is enough to satisfy the claim. Possible their money was used, as opposed to other investors' money, to purchase the asset. Enough to pay for shares in mixed account.
- Mixed account was not used to purchase the asset, therefore not proportionately owned by all the investors because they did not pay for the shares, as RAM used funds from Priest.
- MB: RAM, who breached trust obligations, should not be able to choose that they had used Priest's money in relation to mixed pool – rather than apply a proportionate sharing from tracing
- Applying the ordinary rules of tracing, Priests should not be able to subordinate the claims of other innocent beneficiaries however courts permit it. This is contrary to Re Hallet where beneficiaries can only subordinate the interests of the trustee.