

LEVEL

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The Law of Tracing

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>> Overview

A. Concepts

- 1. Three foundational concepts
- 2. What is tracing?

B. Common law tracing

- 3. Common law tracing: an illusion

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- 7. Recent case: *Caron v Jahani (No 2)* [2020] NSWCA 117
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>> Foundations (1): Legal and equitable property

- Common misconception that legal proprietary rights and equitable proprietary rights are the same in nature and the way they behave.
 - Subject to one qualification: equitable proprietary rights are *weaker* or *more fragile* because they can be extinguished where the legal title is acquired by a bona fide purchaser for value without notice.
- “Mirror image” view.
 - Treated separately only because of the historical equity-common law divide.

>> Foundations (1): Legal and equitable property

Legal title



Mirror



Equitable/beneficial title



>> Foundations (1): Legal and equitable property

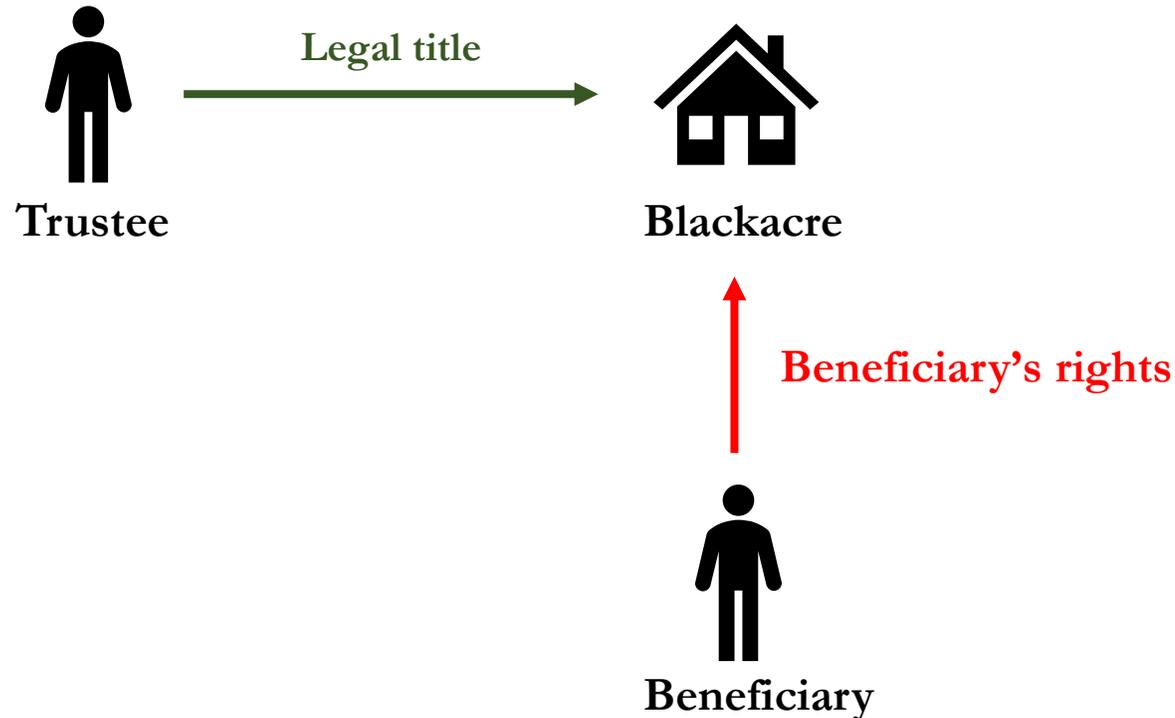
- F Maitland, *Lectures on Equity* (Cambridge University Press, 1929) at 17-18:
 - “An examiner will sometimes be told that whereas the common law said that the trustee was the owner of the land, equity said that the cestui que trust was the owner ... Think what that would mean were it really true. There are two courts of co ordinate jurisdiction one says that A is the owner, the other says that B is the owner of Blackacre. That means civil war and utter anarchy.”
- *Commissioner of Taxation v Linter Textiles Australia Ltd* (2005) 220 CLR 592 at [52]-[53]:
 - “Where A holds Blackacre on a bare trust for B, it may accurately be said that B is the beneficial owner ... But that use of the word “owner” does not entail enjoyment by B of all the rights which the law as a whole confers in relation to Blackacre.”

>> Foundations (2): Equitable proprietary rights

- What is the nature of equitable proprietary rights?
- What is the nature of a beneficiary's rights under a trust?

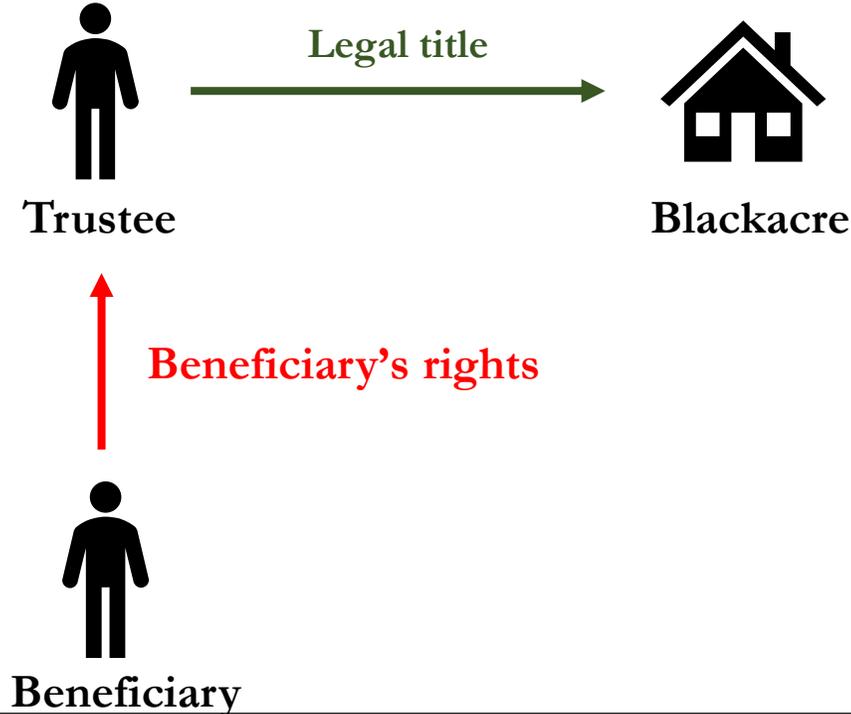
>> Foundations (2): Equitable proprietary rights

- (1) The “proprietary view” - creation of a trust gives the beneficiary a right to, or an equitable estate in, the property legal title to which is held on trust.



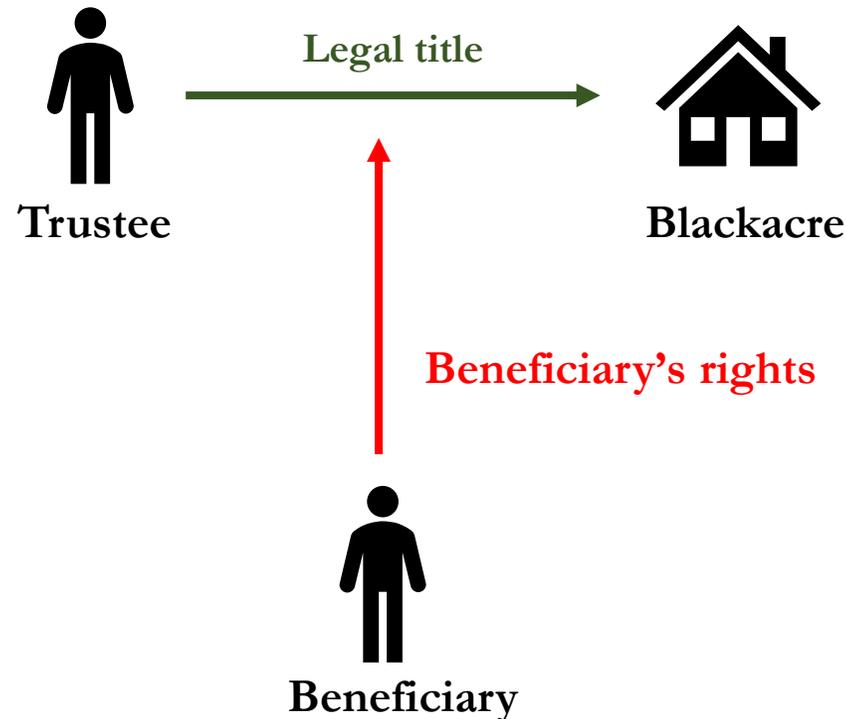
>> Foundations (2): Equitable proprietary rights

- (2) The “obligational view” - creation of a trust imposes particular duties on the trustee, and the rights acquired by the beneficiary are purely personal rights against the trustee.



>> Foundations (2): Equitable proprietary rights

- (3) “Rights against rights” - the beneficiary has rights against the trustee’s legal title to the asset; a right that the trustee hold his title to the asset for the beneficiary’s benefit.



See McFarlane and Stevens, “The nature of equitable property” (2010) 4 *Journal of Equity* 1; Justice Edelman, “Two Fundamental Questions for the Law of Trusts” (2013) 129 *Law Quarterly Review* 66.

>> Foundations (2): Equitable proprietary rights

- Equitable proprietary rights as “rights against rights” in the cases.
- *DKLR Holding Co (No 2) Ltd v Commissioner of Stamp Duties* [1980] 1 NSWLR 510 per Hope JA:
 - “Where the trustee is the owner of the legal fee simple, the right of the beneficiary, although annexed to the land, is a right to compel the legal owner to hold and use the rights which the law gives him in accordance with the obligations which equity has imposed on him. The trustee, in such a case, has at law all the rights of the absolute owner in fee simple, but he is not free to use those rights for his own benefit in the way he could if no trust existed. Equitable obligations require him to use them in some particular way for the benefit of other persons.”

>> Foundations (2): Equitable proprietary rights

- Equitable proprietary rights as “rights against rights” in the cases.
- *Re Transphere Pty Ltd* (1986) 5 NSWLR 309 per McLelland J:
 - “Where a legal owner holds property on trust for another, he has at law all the rights of an absolute owner but the beneficiary has the right to compel him to hold and use those rights which the law gives him in accordance with the obligations which equity has imposed on him by virtue of the existence of the trust. Although this right of the beneficiary constitutes an equitable estate in the property, it is engrafted onto, not carved out of, the legal estate.”

>> Foundations (2): Equitable proprietary rights

- Equitable proprietary rights as “rights against rights” in the cases.
- *Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth* [2019] HCA 20 per Bell, Gageler and Nettle JJ (with whom Gordon J generally agreed):
 - “... a trustee as legal owner of the trust assets has all the powers incidental to ownership subject only to the power of the beneficiaries to compel the trustee to exercise the trustee’s powers in accordance with the terms of trust. Inasmuch as a court of equity will aid the beneficiaries in the enforcement of the terms of trust, the beneficiaries are described, especially in revenue contexts, as having a beneficial interest in, or occasionally even beneficial ownership of, the trust assets. The beneficiaries’ interest is not, however, to be conceived of as cut out of the trustee’s legal estate but rather as engrafted onto it as a restriction on the manner in which the trustee may deal with trust assets.”
- *Commissioner of State Revenue v Rojoda Pty Ltd* [2020] HCA 7 at [44] per Bell, Keane, Nettle and Edelman JJ:
 - ... it is fundamental that the creation of a trust involves the creation of new equitable obligations, which are ‘annexed to the trust property’ or ‘engrafted’ or ‘impressed upon it’. The creation of a trust never involves ‘movement’ of property in the sense of a conveyance of title from one person to another.

>> Foundations (2): Equitable proprietary rights

- Equitable proprietary rights as “rights against rights” in the Queensland cases.
- *O’Sullivan v Commissioner of Stamp Duties* [1984] 1 Qd R 212 at 229-230
- *Francis v NPD Property Development Pty Ltd* [2005] 1 Qd R 240 at [4]
- *R v Hart* [2005] QCA 50 at [13]
- *Legal Services Commissioner v Dempsey* [2008] 2 Qd R 272 at [38]
- *Can Barz Pty Ltd & Anor v Commissioner of State Revenue & Ors* [2017] 1 Qd R 222 at [32] (appeal dismissed: [2017] 2 Qd R 537)

>> Foundations (3): Rights, not things, held on trust

- Understanding the nature of equitable proprietary rights allows us to see that the subject matter of a trust is always the rights held by the trustee. It is never the actual asset in respect of which the trustee has rights or title.
- It is therefore inaccurate to speak of a trustee holding land on trust for a beneficiary. Rather, the trustee holds the legal title to the land on trust for the beneficiary.
- *Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth* [2019] HCA 20 per Kiefel CJ, Keane and Edelman JJ: the expression “‘trust assets’ ... [is] simply shorthand for ... the rights held on trust by the trustee”.

>> What is tracing?

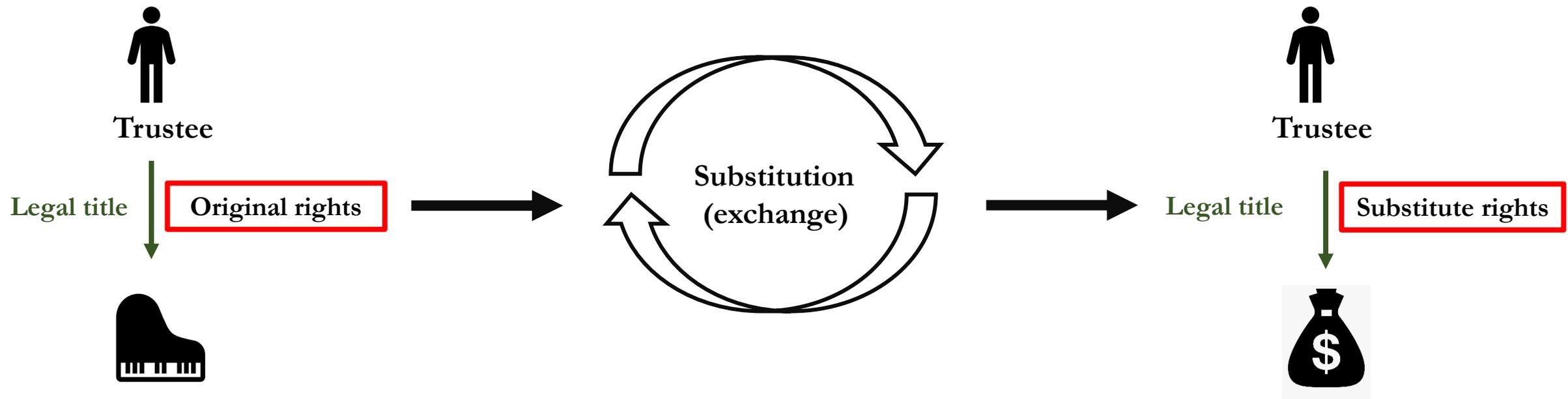
- Tracing and following
 - *Foskett v McKeown* [2001] 1 AC 102 at 127 per Lord Millett:
 - “Following is the process of following the same asset as it moves from hand to hand. Tracing is the process of identifying a new asset as the substitute for the old.”
 - More accurate (our view):
 - Following is the exercise of locating the subject matter of a right.
 - Tracing is concerned with when one set of rights (the substitute rights) can stand in the place of another set of rights (the original rights).
- Tracing is neither a claim nor a remedy

>> What is tracing?

- What do we trace?
- Value?
 - Lionel Smith, *The Law of Tracing* (1997); *Foskett v McKeown*
 - Problem: value does not move from one asset to another
- Causally-linked transactions?
 - Justice Edelman and Elise Bant, *Unjust Enrichment* (2016); Justice Edelman, “Understanding Tracing Rules” (2016) 16 *QUT Law Review* 1
 - Problem: cannot explain the cases (both under-inclusive and over-inclusive).
 - Tracing is about attribution, not causation: *Foskett, Hanson v Goomboorian Transport Pty Ltd* [2019] QCA 41.

>> What is tracing?

- Our answer: tracing is concerned with the unauthorised use of rights (the original rights) to acquire or create new rights (the substitute rights) in circumstances which, generally speaking, must amount to a substitution.

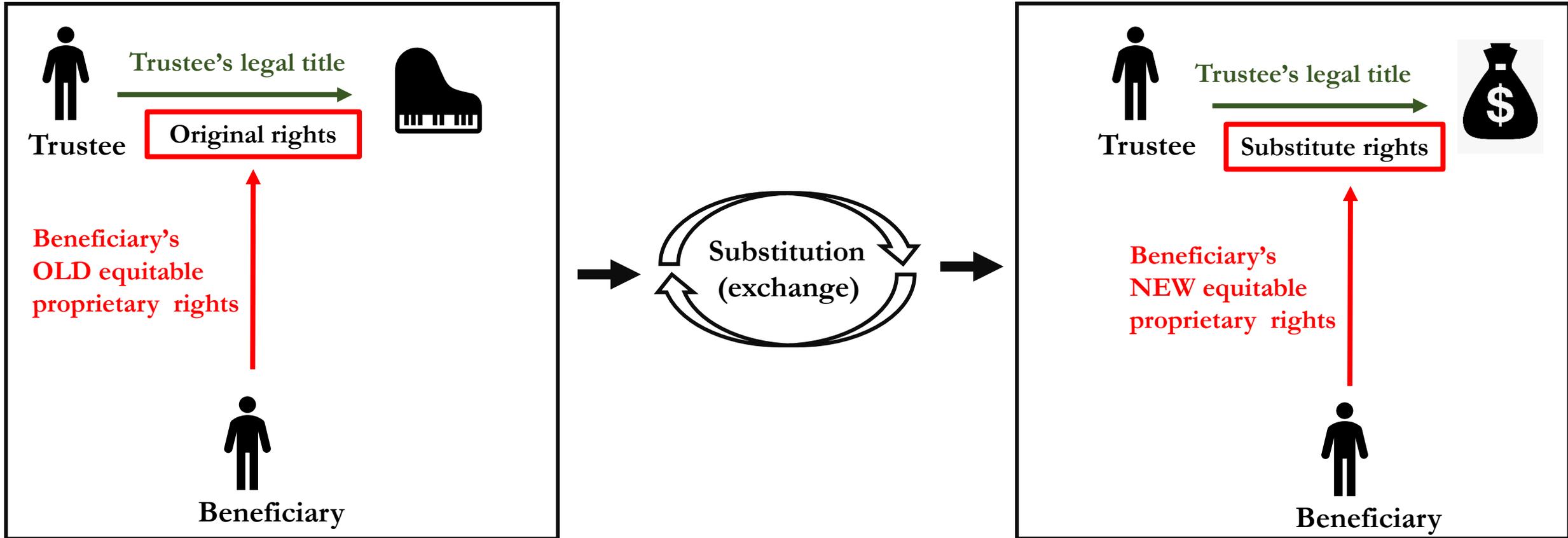


>> What is tracing?

- What is the effect of tracing?
- Our answer: Tracing confers upon the claimant new equitable proprietary rights against the substitute rights which mirror (so far as is possible) the equitable proprietary rights the claimant had against the original rights.
- These are new rights. They are not the claimant's pre-existing rights (cf *Foskett*).

>> What is tracing?

- Drawing the ideas together:



>> Common law tracing: an illusion

- Orthodox view: tracing at law and equity are distinct
 - *Re Diplock* [1948] Ch 465; criticised in *Foskett v McKeown* [2001] 1 AC 102 at 128
- Genesis of common law tracing: *Taylor v Plumer* (1815) 3 M&S 562
 - Actually about tracing in equity!
 - Mistake recognised in *Jones v Jones* [1997] Ch 159 but considered too late to turn back.
- Australian law?
 - Mohammud Jaamae Hafeez-Baig & Jordan English, ‘Common Law Tracing: The Emperor’s New Clothes?’ (2018) 12 *Journal of Equity* 260

>> Equitable Tracing: Prerequisites

- The general requirement of an “equitable proprietary right”
 - Sometimes referred to as the need to establish a “proprietary base”: *Grimaldi v Chameleon Mining (No 2)* (2012) 200 FCR 296 at 417 [560]:
 - “[I]f you wish to trace from asset A into asset B (as its traceable proceeds), you must first establish that you have proprietary rights in asset A. You must establish your ‘proprietary base.’”
- A legal owner, without more, cannot trace in equity: *Russell Gould Pty Ltd v Ramangkura* (2014) 87 NSWLR 552 at 557.
 - Legal owner *may* trace in equity if events have given rise to an equitable proprietary right.
 - Legal owner may also trace in equity if he or she has given control of the property to a person in circumstances which imposes fiduciary obligations with respect to the property (eg fiduciary bailments)
- Is there a further requirement e.g. a fiduciary relationship in *all* cases?

>> Equitable Tracing: Prerequisites

- In England, fiduciary relationship treated as requirement in *all* cases:
 - *In re Hallett's Estate* (1880) 13 Ch 696 at 710; *In re Diplock* [1948] Ch 465 at 520; *Agip (Africa) Ltd v Jackson* [1991] Ch 547 at 566.
 - Position has been criticised, eg, *Foskett v McKeown* [2001] 1 AC 102 at 128-129 (Lord Millett).
- In Australian law, weight of authority is that it is not a requirement.
 - Compare:
 - *Re Global Finance Group Pty Ltd (in liq)* (2002) 26 WAR 385 at 407 [96] (McLure J); and
 - *Hurt v Freeman* [2002] NSWSC 264 at [223] (Santow J); *Commonwealth Bank of Australia v Saleh* [2007] NSWSC 903 at [29] (Einstein J); *Puma Australia Pty Ltd v Sportsman's Australia Ltd (No 2)* [1994] Qd R 159 at 163-164 (McPherson ACJ).

>> Equitable Tracing: Prerequisites

- Conclusion:
 - Australian authority is against the requirement for a fiduciary relationship in all cases.
 - However, there must be an “equitable proprietary right” or a fiduciary duty in relation to the property:
 - *Re French Caledonia Travel* (2003) 59 NSWLR 361 at 393 [108]:
 - “But tracing, resulting in an order for an equitable charge, could occur into an asset in the custody of an entity which was not a fiduciary, if the person seeking to trace had an equitable right of property in that asset.”

>> Equitable Tracing: Mixing (Wrongdoers)

- One problem posed by mixing: withdrawals from a mixed fund creates uncertainty.
- Example: A trustee misappropriates \$100 of trust money and combines it with \$100 of his own money in a mixed fund. The trustee then uses \$100 from the mixed fund to purchase a bicycle.
- There is uncertainty as to what money the trustee used. Three options:
 - (i) the trustee used \$100 of his own money (money to which he held legal title beneficially),
 - (ii) the trustee used \$100 of trust money (money to which he held legal title on trust), or
 - (iii) the trustee used some combination of trust money and his own money.

>> Equitable Tracing: Mixing (Wrongdoers)

- We address the uncertainty with two rules.
- (1) The rule in *Re Hallett's Estate* (1880) 13 Ch D 696: treats the wrongdoer as having withdrawn his or her own money first; allows the beneficiary to trace into the money remaining in the fund.
 - *Brady v Stapleton* (1952) 88 CLR 322 at 336-339; *Heperu Pty Ltd v Belle* (2009) 76 NSWLR 230 at [114]; *Raulfs v Fishy Bite Pty Ltd* [2012] NSWCA 135 at [95]; *Russell Gould Pty Ltd v Ramangkura* (2014) 87 NSWLR 552 at [75]; *Leighton Contractors Pty Ltd v O'Carrigan* [2016] QSC 223 at [97]-[99].
- Example: Trustee knowingly mixes \$10,000 of his money with \$10,000 of trust money and dissipates \$10,000 from the mixture.

>> Equitable Tracing: Mixing (Wrongdoers)

- (2) The rule in *Re Oatway* [1903] 2 Ch 356: treats the wrongdoer as having purchased the substitute right using trust money and as having dissipated his or her own money.
 - *Heperu Pty Ltd v Belle* (2009) 76 NSWLR 230 at [114]-[115]; *Australian Receivables Ltd v Tekitu Pty Ltd* [2011] NSWSC 1306 at [145]-[147]; *Birketu Pty Ltd v Westpac Banking Corporation (No 2)* [2018] NSWSC 494 at [56]; *Nadilo v Souris* [2019] NSWSC 108 at [94]-[96].
- Example: Trustee knowingly mixes \$10,000 of his own money with \$10,000 of trust money. He purchases a profitable investment with \$10,000 and then dissipates the remaining \$10,000.

>> Equitable Tracing: Mixing (Wrongdoers)

- Cherry picking?
 - “[I]f the beneficiary is not entitled to [cherry-pick], the wrongdoing trustee may be left with all the cherries and the victim with nothing”: *Shalson v Russo* [2005] Ch 281 at [144].
- Example: Trustee knowingly mixes \$10,000 of his own money with \$10,000 of trust money. He purchases a profitable investment with \$10,000, and there is still \$10,000 remaining.
- “Where a fund mixed with trust money is used to acquire other property, the beneficiary is entitled to charge both the fund and any property acquired from that fund ...”: *The Uniting Church in Australia Property Trust (NSW) v Vincent* [2009] NSWSC 375 at [9].

>> Equitable tracing: “lowest intermediate balance” rule

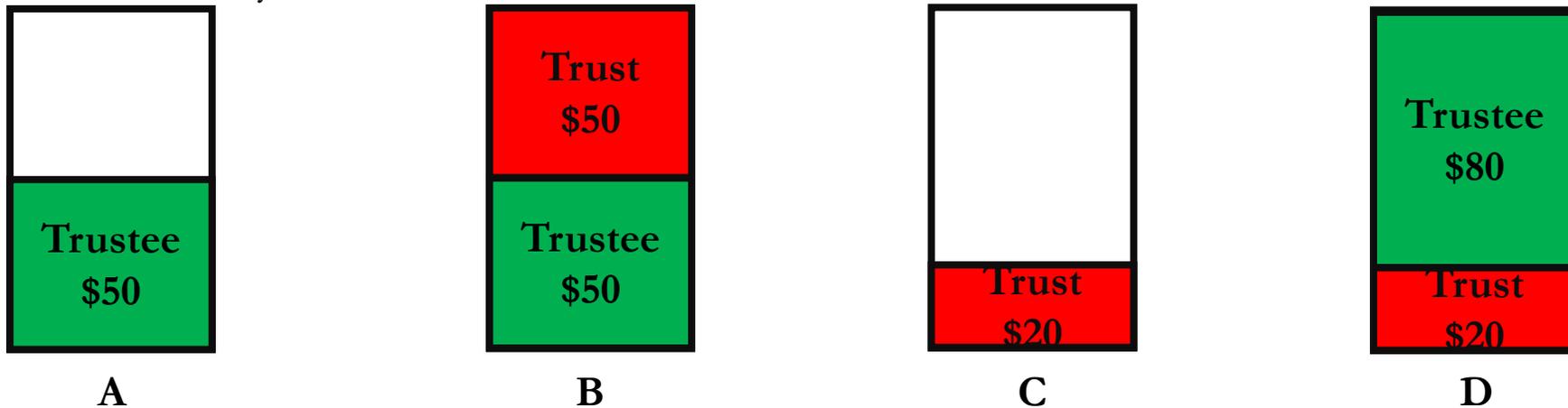
- Rules do not apply where no uncertainty.
- *Re French Caledonia Travel Service Pty Ltd* (2003) 59 NSWLR 361 at 417-418 [175]
 - “... tracing cannot occur through a mixed account for any larger sum than is the lowest balance in the account between the time the [trust] money goes in, and the remedy is sought.”
- Rule applies even if trustee subsequently pays money into the fund so as to restore the original balance.
 - Qualification: funds subsequently paid into the mixed fund may go towards making good earlier deprecations if this was the intention of the trustee in paying in the funds (see *James Roscoe (Bolton) Ltd v Winder* [1915] 1 Ch 62). There is no presumption or deeming rule to this effect.

>> Equitable tracing: “lowest intermediate balance” rule

- Example: Trustee takes \$50 of trust money and mixes it with \$50 of his own money. Trustee then dissipates \$80. Later the trustee deposits \$80 of his own money into the account, bringing the balance back up to \$100.
- One “unprincipled” approach:
 - Account has \$100 in it; this is more than \$50.
 - Beneficiary can assert equitable proprietary rights as security for personal claim to the extent of \$50.

>> Equitable tracing: “lowest intermediate balance” rule

- Another approach: apply the deeming rules and take account of subsequent deposits and withdrawals:
 - Trustee deemed to have dissipated own money first. Therefore dissipated \$50 of his own money and \$30 of trust money. Only \$20 of trust money left.
 - Beneficiary can assert equitable proprietary rights as security for personal claim to the extent of \$20 only.



- “Lowest intermediate balance” in the account between the time the trust money was deposited and the trial is \$20.

>> Equitable Tracing: Mixing (Innocent Claimants)

- Example: Trustee knowingly mixes \$10,000 of trust money from Trust A with \$10,000 of trust money from Trust B. He purchases a profitable investment with \$10,000 and then dissipates the remaining \$10,000.
- General rule: rateable / *pari passu* distribution
 - *Foskett v McKeown* [2001] 1 AC 102 at 132 per Lord Millett:
 - “Innocent contributors, however, must be treated equally inter se ... The primary rule in regard to a mixed fund, therefore, is that gains and losses are borne by the contributors rateably.”

>> Equitable Tracing: Mixing (Innocent Claimants)

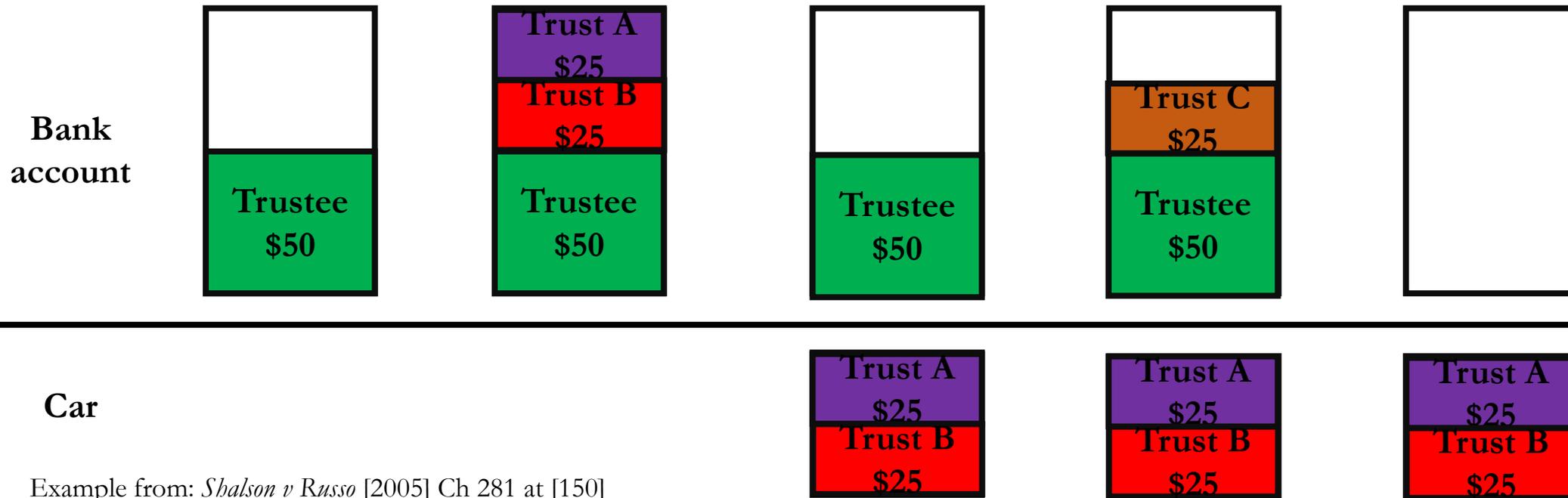
- The rule in *Clayton's Case* (1816) 35 ER 781 (first in, first out)
 - *Clayton's Case* was a case about appropriation of payments, not about tracing.
 - The rule in *Clayton's Case* has been discarded in Australia.

>> Equitable Tracing: Mixing (Innocent Claimants)

- Rolling charge / North American model:
 - *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22 at 35 per Woolf LJ:
 - “This solution involves treating credits to a bank account made at different times and from different sources as a blend or cocktail with the result that when a withdrawal is made from the account it is treated as a withdrawal in the same proportions as the different interests in the account ... bear to each other at the moment before the withdrawal is made.”
 - A version of the “lowest intermediate balance” rule
 - *Law Society of Upper Canada v Toronto-Dominion Bank* (1998) 169 DLR (4th) 353 at [25]; *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337 at [141]

>> Equitable Tracing: Mixing (Innocent Claimants)

- Example: Trustee takes \$25 from Trust A and \$25 from Trust B and mixes it with \$50 of his own money. His account has a balance of \$100. Trustee uses \$50 to buy a car. He then takes \$25 from Trust C and deposits it in the account. His account has a balance of \$75. Trustee dissipates all \$75.



Example from: *Shalson v Russo* [2005] Ch 281 at [150]

>> Equitable Tracing: Mixing (Innocent Claimants)

- Rateable / *pari passu* distribution:
 - Beneficiaries of Trusts A, B, and C can trace into legal title to the car.
 - BUT we know, as a matter of fact, that the money from Trust C could not have contributed to the purchase of the car.
- Rolling charge / North American model:
 - Beneficiaries of Trusts A and B can trace into legal title to the car.
 - Beneficiary of Trust C cannot.
- Tension between acceptance of both the simple *pari passu* rule and the “lowest intermediate balance” rule (of which the rolling charge model is a version).
 - *Re Magarey Farlam Lawyers Trust Accounts (No 3)* (2007) 96 SASR 337 at [141] per Debelle J.
 - But see *Caron* [2020] NSWCA 117 at [119].



Caron v Jahani (No 2) [2020] NSWCA 117

- Facts:
 - Company operated a Ponzi scheme. Company insolvent.
 - On 21 April 2017, Company's bank account was frozen.
 - Respondent (representing several creditors) deposited funds prior to the freezing order.
 - Appellants (representing several creditors) deposited funds on or after the freezing order until 26 April 2017.
- Issue: how should the remaining funds be distributed in insolvency?
- Primary judge: applied simple *pari passu* approach. Court of Appeal allowed the appeal, permitting individual investors to prove their entitlement applying lowest intermediate balance rule.

>> *Caron v Jahani (No 2)* [2020] NSWCA 117

- Noted that rule in *Clayton's Case* had been rejected, and noted the two alternatives: (i) simple pari passu; (ii) lowest intermediate balance (at [12], [14]).
- Noted the objections to the “lowest intermediate balance” rule / rolling charge model:
 - “The objections to the application of the lowest intermediate balance rule rest not on principle, but in a practical concern relating to the cost and complexity of its application.” (Bell P at [120]).



Caron v Jahani (No 2) [2020] NSWCA 117

- Preferred “lowest intermediate balance” rule / rolling charge model:
 - “... the lowest intermediate balance rule recognises the continuing vitality of ‘clearly discernible separate property rights’ ... and is a means of identifying them.” (Bell P at [145])
 - “Where evidence is available ... the lowest intermediate balance rule has been applied and provides what, in my opinion, is the fairest, most equitable and principled outcome for the allocation of limited funds between investors.” (Bell P at [146])

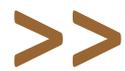
>> *Caron v Jahani (No 2)* [2020] NSWCA 117

- Advantages of “lowest intermediate balance” rule / rolling charge model:
 - “[The ‘lowest intermediate balance’ rule] is more consistent with equitable principle and the rules of tracing. The simple *pari passu* approach may also result in later investors whose funds were not, or were not significantly, dissipated, cross-subsidising earlier investors whose funds had, at least to some extent, been lost prior to any involvement of later investors.” (Bell P at [147])



Caron v Jahani (No 2) [2020] NSWCA 117

- Proof by individual claimants:
 - “If a claimant insists on exercising a right to trace into a mixed fund ... he, she or it may do so (even though the liquidator otherwise seeks the Court’s blessing for a *pari passu* distribution). This is an exercise in the vindication of proprietary rights or interests. Unlike the liquidator seeking directions, such a claimant will need to be able to establish, on the balance of probabilities, the proprietary interest claimed ...” (Bell P at [152])



Caron v Jahani (No 2) [2020] NSWCA 117

- A simplified rolling charge approach?
 - *Caron* involved a *partial* application of the rolling charge method: the ‘simplified rolling charge approach’.
 - Application of simplified rolling charge approach was rejected in England in *Charity Commission for England and Wales v Framjee* [2015] 1 WLR 16 (not discussed in *Caron*).
 - *Caron* is to be preferred. Courts should, where possible, give effect to the lowest intermediate balance rule by applying the rolling charge approach even if only in part.
 - J English and M J Hafeez-Baig, ‘Tracing, Mixing, and Innocent Claimants’ (2020) *Modern Law Review* (forthcoming).

>> Equitable Tracing: Special Cases

- Tracing into payment of a debt (e.g. overdrawn accounts)
 - *Re Global Finance Group Pty Ltd (in liq)* (2002) 26 WAR 385 at [129]:
 - “The overwhelming balance of authority is to the effect that a proprietary claim to the traceable product will fail if trust money is paid into an overdrawn account”.
 - Approved of in *Williams v Peters* [2010] 1 Qd R 475
 - *Russell Gould Pty Ltd v Ramangkura* (2014) 87 NSWLR 552 at [33]:
 - “Importantly, neither the common law nor equity allows money to be traced into a bank account which is overdrawn ...”

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>> Equitable Tracing: Special Cases

- Subrogation
 - If money can be followed or traced into discharge of another's debt, secured by a charge, plaintiff may be entitled to the remedy of subrogation: *Heperu Pty Ltd v Belle* (2009) 76 NSWLR 230 at [135].
- Backwards tracing
 - *Federal Republic of Brazil v Durant International Corp* [2016] AC 297
 - “... 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.”
 - *Leighton Contractors Pty Ltd v O’Carrigan & Ors* [2016] QSC 223 at [104] to [108]
 - Applied *Federal Republic of Brazil v Durant*.

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>> Equitable Tracing: Bars

- Bona fide purchaser for value without notice
- Dissipation/non-identifiability

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Questions?

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