

D4:4.4.2: TRACING RULES: A BRIEF SUMMARY¹

1. Introduction and An Easy Case

- Tracing is a process that allows one right to be identified as a product of another. In some situations, that identification process is very easy.

D4:Example 12d: B has some shares. B sells those shares to A for £800. A later sells the shares for £800 and then uses that £800 to buy a car from C.²

In **D4:Example 12d**, B can identify A's Ownership of the car as a product of B's initial right to the shares (ie of the initial personal right of B represented by the shares). Of course, this does not mean that B has a right against the car; or against A's Ownership of the car; or against A (see p 325).

2 Where One of the Parties is a Wrongdoer

- In other situations, the identification process is more difficult.

Example 1a: A holds a bank account (account 1) on Trust for B1. A also has his own bank account (account 2): that account is £10,000 in credit. A, acting beyond his powers as trustee, transfers £10,000 from account 1 into account 2. A then uses the £20,000 credited to account 2 to: (i) buy some shares for £10,000; and (ii) buy a painting for £10,000. B1 then discovers what A has done. A still holds both the shares and the painting. The shares have increased in value to £20,000; but the painting is a worthless fake. A has gone into insolvency.

In such a situation, B1 will wish to show that he has a persistent right against A's right to the shares (see **B:4.5.2**). To do so, B1 will need to show that A's right to the shares counts as the product of the right initially held on Trust for B1 (account 1). B1's argument is plausible: it is not impossible that A's right to the shares, acquired after account 2 was credited with £10,000 from account 1, is the product of account 1. However, there is a basic evidential problem: we do not know whether the £10,000 spent on the shares is the product of the value transferred from account 1. It could just as well be the case that the painting bought for £10,000 is, instead, the product of the value transferred from account 1.

In such a case, a clear general principle applies: *doubts are resolved against the wrongdoer*.³ A is a wrongdoer as, when transferring the £10,000 from account 1, he acted beyond his powers as trustee. So, a court will find that the £10,000 spent on the shares is the product of the £10,000 debited from account 1; and the £10,000 spent on the painting is the product of the £10,000 initially credited to account 2. This means that:

¹ For a thorough analysis see L Smith, *The Law of Tracing* (Oxford, OUP, 1997).

² **D4:Example 12d**, as set out on p 325 of the book, is inaccurate: it misses out the crucial point that A sells the shares and then uses *that* £800 to buy C's car.

³ See eg *re Hallett's Estate* (1880) 13 Ch D 696; *re Oatway* [1903] 2 Ch 356.

- i) A's right to the shares is the product of account 1; *and*
- ii) That account was initially held by A on Trust for B; *and*
- iii) There is no legal basis for A to have the benefit of A's right to the shares;
so
- iv) A holds his right to the shares on a Resulting Trust for B (see D4:4.4).

- The principle of resolving doubts against a wrongdoer can only apply if there is a doubt to be resolved. So, a court cannot punish a wrongdoer by *pretending*, in the face of evidence, that a particular right held by A is the product of another right.

Example 1b: A holds a bank account (account 1) on Trust for B1. A also has his own bank account (account 2): that account is £10,000 in credit. A, acting beyond his powers as trustee, transfers £10,000 from account 1 into account 2. A then uses the £20,000 credited to account 2 to buy a painting: that painting turns out to be worthless. A then receives a £10,000 legacy from his grandmother. That money is paid into account 2, which is now £10,000 in credit. A goes into insolvency.

In such a situation, B1 *cannot* show that A's right against his bank to £10,000 is a product of the right initially held by A on Trust for B (account 1). We know that the whole value of account 1 went into buying the worthless painting; and that the £10,000 credited to account 2 came not from account 1 but from A's grandmother.⁴

Example 1c: A holds a bank account (account 1) on Trust for B1. A also has Ownership of a car. A bought that car by borrowing £9,000 from a lender; A now owes that lender £10,000. Acting beyond his powers as trustee, A transfers £10,000 from account 1 to the lender. A goes into insolvency.

In such a case, B1 may wish to show that he has a persistent right against A's Ownership of the car. To do so, B1 needs to show that A's Ownership of the car is a product of account 1. However, A acquired his Ownership of the car *without* making any use of account 1: A had his right *before* transferring £10,000 out of account 1. So, logically, A's Ownership of the car cannot be a product of account 1: this type of "backwards tracing" has not been accepted by the courts (although see p 760 of the book).⁵

- **So, the first general tracing principle is that doubts are to be resolved against a wrongdoer.**
- **but no doubts exist if we know that the value of one right could not have contributed to another right (eg because the value of the first right was used up before the acquisition of the second right; or because the second right was acquired before the first right was used).**

⁴ See eg *Roscoe v Winder* [1915] 1 Ch 62; *Space Investments Ltd v CIBC Trust Co (Bahamas) Ltd* [1986] 1 WLR 1072. This rule is often known as the "lowest intermediate balance" rule: in **Example 1b**, the lowest balance in account 2 between the transfer of the £10,000 from account 1 and the time of B's claim is zero; and so B cannot show that any right held by A is, in whole or in part, a product of account 1.

⁵ See eg the doubts of Leggatt LJ in *Bishopsgate Investment Management Ltd v Homan* [1995] Ch 211 at 221. There is however some academic support for such "backwards tracing": see L Smith [1995] CLJ 290.

3 Where there is a Dispute between Two or More Innocent Parties

Example 2a: A holds a bank account (account 1) on Trust for B1. A also has his own bank account (account 2): that account is £10,000 in credit. Under a separate Trust, A also holds a third bank account (account 3) on Trust for B2. A, acting beyond his powers as a trustee for B1, transfers £10,000 from account 1 into account 2. And, acting beyond his powers as a trustee for B2, A also transfers £10,000 from account 3 into account 2. A then uses the £30,000 credited to account 2 to: (i) buy some shares for £10,000; and (ii) buy a painting for £20,000. B1 and B2 then discover what A has done. A still holds both the shares and the painting. The shares have increased in value to £20,000; but the painting is a worthless fake. A has gone into insolvency.

Applying the general principle that doubts are to be resolved against a wrongdoer, we can say that all of the £10,000 initially credited to account 2 has been spent on the worthless painting. However, we still have a problem: a further £10,000 has been spent on the painting and that value must be the product of: (i) account 1; or (ii) account 3; or (iii) partly account 1 and partly account 3. So, B1 will claim that the further £10,000 spent on the painting is the product of account 3; if so, A's right to the shares is entirely the product of account 1 and so A will hold that right on Trust for B1. In contrast, B2 will claim that the further £10,000 spent on the painting is the product of account 1; if so, A's right to the shares is entirely the product of account 3 and so A will hold that right on Trust for B2.

In resolving that dispute between B1 and B2, we cannot use the general principle of resolving doubts against a wrongdoer: neither B1 nor B2 is a wrongdoer. Instead, we have to use the second general principle: *innocent parties are to be treated as equals*. Crucially, treating B1 and B2 *as equals* is not the same as treating them equally. So, in **Example 2a**, it is possible to treat B1 and B2 as equals *without* necessarily deciding that the shares are 50% the product of account 1 and 50% the product of account 3. To treat B1 and B2 as equals, we simply need to apply a rule that, in the abstract, does not discriminate between any particular innocent party. For example, if two parties are playing one game of chess, we cannot treat them equally: one party must take the white pieces and so get the advantage of the first move. However, we can treat the parties as equals by ensuring that each has an equal chance of taking the white pieces: eg by deciding on colours by tossing a coin.

The courts have developed various different rules that can be used to treat the parties as equals. We can consider these rules by seeing their effect in **Example 2a**.

- The “**first in, first out**” rule: In **Example 2a**, the first credit into account 2 came from account 1. That credit is then viewed as first out: as A bought the shares before the painting, this rule means that A's right to the shares is *wholly* the product of account 1. So, A holds those shares on Trust wholly for B1. B2 has no right against A's right to the shares, as the credit from B2's account is viewed as going on the second purchase: the painting. This “first in, first out” rule is often referred to as the rule in *Clayton's Case*.⁶

⁶ (1816) 1 Mer 529.

- The “**intention**” rule: This rule depends on the intention (at the time of the relevant transaction) of the party making that transaction. So, let us say that, in **Example 2a**, A’s conduct shows that he intended to use the value from account 1 to buy the shares; and the value from account 3 to buy the painting. *If* A had such an intention, a court can then follow it by viewing the shares as the product of account 1 (and so held on Trust by A entirely for B1’s benefit); and the painting as the product of account 3 (and so held on Trust by A entirely for B2’s benefit).
- The “**overall proportions**” rule: In **Example 2a**, the accounts held on Trust for B1 and B2 each contributed £10,000 to A’s account. As B1 and B2 made equal contributions to the input into account 2, each is viewed as making equal contributions to the outputs. So, A’s right to the shares is viewed as 50% the product of account 1 and 50% the product of account 3. So, A holds those shares on Trust 50% for B1’s benefit and 50% for B2’s benefit. This rule is often referred to as the “*pari passu*” approach.
- The “**rolling proportions**” rule: This rule (often referred to as the “*rolling pari passu*” approach) is a refinement of the “overall proportions rule”: it means that the contributions of the innocent parties are calculated *after each relevant transaction*. In **Example 2a**, this rule is no different to the “overall proportions” rule as there is only one relevant transaction. However, in other situations, the two rules can lead to different results (see **Example 2b below**).

Each of these approaches meets the basic test of treating B1 and B2, two innocent parties, as equals; but deciding the issue by tossing a coin would also meet that test. So, which of the approaches is best?

Example 2b: A holds a bank account (account 1) on Trust for B1. A also has his own bank account (account 2): but that account is not in credit (nor is it in overdraft). Under a separate Trust, A also holds a third bank account (account 3) on Trust for B2. A, acting beyond his powers as a trustee for B1, transfers £10,000 from account 1 into account 2. A then spends £10,000 from account 2 on buying shares that increase in value to £20,000. A, acting beyond his powers as a trustee for B2, then transfers £10,000 from account 3 into account 2. A then uses the £10,000 credited to account 2 to buy a painting that turns out to be worthless. A then goes into insolvency.

On the “**first in, first out**” rule, as in **Example 2a**, account 1 is viewed as contributing only to the shares; and account 3 contributes only to the painting. This rule works well for B1: as account 1 has contributed the cost of the shares, A holds his right to the shares on Trust for B1. In contrast, the rule works badly for B2: as account 3 has contributed only to the painting, A holds his (worthless) right to the painting on Trust for B2.

The “**intention**” approach cannot apply: A, when buying the shares and the painting, had no particular intention as to whether he was using the value of B1’s contribution or of B2’s contribution.

On the “**overall proportions**” approach, it can be said that, *overall*, each of B1 and B2 has contributed £10,000 to the value of account 2. As a result, B1 and B2 could be seen

as equally contributing to the outputs from that account. So, A's right to the shares (like his right to the painting) is viewed as 50% the product of account 1 and 50% the product of account 3. So, A holds those shares on Trust 50% for B1's benefit and 50% for B2's benefit.

The **“rolling proportions”** approach leads to a different result. The first relevant transaction was A's purchase of the shares. At that point, B1 had contributed £10,000 to the value of account 2. As a result, B1 can be seen as contributing the money used by A to buy the shares: so A holds those shares on Trust for B1. In contrast, as account 3 did not contribute to the acquisition of the shares, B2 has no right against A's right to the shares.

From this example, the **“rolling proportions”** approach can be seen to have important benefits. First, it avoids the arbitrary results that may come from the **“first in, first out”** or **“intention”** rules: an innocent party may reasonably feel that the accident of A breaching one Trust before the other, or of A's intentions when making the relevant transactions, should not affect his rights. The **“overall proportions”** approach moves towards a more rational position, as it is based on overall contributions of the parties. However, it may seem odd that, in **Example 2b**, the shares (acquired before any value was taken from account 3) should be seen as, in part, the product of account 3. The **“rolling proportions”** approach avoids that problem: it shows that the **“overall proportions”** approach has its own arbitrariness. For it depends on how much value each party contributes overall whenever the music happens to stop: so the parties' rights can depend on the accident of when the transactions end. In contrast, the **“rolling proportions”** can consider each transaction as an individual, complete event.

This analysis broadly fits with the conclusions of the courts. First, a preference has been stated for the **“rolling proportions”** approach.⁷ The problem may be that, in practice, that approach is very difficult for a court to apply: it may involve the unpicking and analysis of a large number of individual transactions. So, for practical reasons, a court may instead prefer the **“overall proportions”** approach⁸ or the **“intention”** approach.⁹ It may even be that, if it can be used, the **“intention”** approach will take priority over the **“rolling proportions”** approach.¹⁰ The **“first in, first out”** approach was traditionally applied where value was contributed to a current account: so, in **Example 2b**, that approach could apply if A's account (account 2) is a current account. However, given the

⁷ See eg *Barlow Clowes International v Vaughan* [1992] 4 All ER 22 (where in fact the “overall proportions” approach was used due to such practical problems).

⁸ As in *Barlow Clowes International v Vaughan* [1992] 4 All ER 22.

⁹ See eg *Boscawen v Bajwa* [1996] 1 WLR 328 at 336. In that case, lawyers held money on Trust for various clients and made deposits into a single account. The lawyers kept contemporary records allocating deposits and withdrawals to particular clients.

¹⁰ See eg *per* Millett LJ in *Boscawen v Bajwa* [1996] 1 WLR 328 at 336: “It is not necessary to apply artificial tracing rules where there has been an actual appropriation”.

arbitrary nature of the rule, it has fallen out of favour and, it seems, should only be used as a last resort if none of the other three rules can provide a workable solution.¹¹

- **So, the second general tracing principle is that *innocent parties should be treated as equals***
- **That principle can be upheld through various means: the best approach seems to be to apply a “*rolling proportions*” rule. Practical problems may mean that, instead an “*overall proportions*” rule should apply. If practical problems remain then, in the case of a current account, the “*first in, first out*” rule may be used. And, in a case where the “*intentions*” rule can be applied, that rule may be preferred as providing a clear answer.**

¹¹ See eg *Barlow Clowes International v Vaughan* [1992] 4 All ER 22; *Russell-Cooke Trust Company v Prentis* [2003] 2 All ER 478.